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No.

Supreme Court, U.S.
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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1987

GUY F. ATKINSON COMPANY OF CALIFORNIA
and SUBSIDIARIES,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1. Under the income tax regulations applicable to long-term contracts, which were designed to ensure prompt tax reporting where disputes remain between the parties following termination of contract performance, is tax reporting proper when the taxpayer has unequivocally ended its work and surrendered the subject matter of the contract to the project owner, the owner has taken possession with the express understanding that the taxpayer's work has concluded, and all of the actual expenses and revenues of the contract operations are known; or must tax reporting be deferred until the uncertain future time when the parties' outstanding contingent claims in litigation are ultimately resolved?

2. May a court of appeals affirm a judgment of the Tax Court on a ground different from that relied upon by the Tax Court, when the court of appeals' affirmance requires resolution of a disputed factual issue not presented to or ruled upon by the Tax Court; or is the taxpayer entitled to a remand of the case in order to have an opportunity to present evidence that might affect the result under the new theory?

LIST OF PARTIES

Petitioners

Guy F. Atkinson Company of California
Atkinson Land Company
Guy F. Atkinson Company
Atkinson Construction Company
Atkinson Development Company
Atkinson-International Dominican Republic Inc.
Atkinson-International Venezuela, Inc.
Columbia Service Company, Inc.
Andrew H. Charles Corporation
Atkinson-Walsh LNG, Inc.
Atkinson-International (Australia) Ltd.
Guy F. Atkinson Company—Overseas
Atkinson-Harney Corporation
Walsh Construction Company, Ltd.

Respondent

Commissioner of Internal Revenue

These parties are identical to those in the proceeding below.

RULE 28.1 LIST

Petitioner Guy F. Atkinson Company of California has no parent company. It is the parent company of the other petitioners. Petitioners' remaining affiliates and subsidiaries (other than wholly owned subsidiaries) are Alliance Valve Corporation Ltd.; AWD Technologies, Inc.; AWD Technologies Canada, Ltd.; Bingham International, Inc. (Delaware); Bingham International, Inc. (Canada); Bombas Bingham, S.A. De C.V.; Calpine Corporation; International General Finance Limited; LUZ Solar Partners, Ltd.; Mull Drilling Co.; and WBL Solar Corporation.

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit, filed April 15, 1987, as amended June 25, 1987.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit, as amended, is reported at 814 F.2d 1388, and is included in the Appendix (pp. A-1 to A-10). The opinion of the United States Tax Court is reported at 82 T.C. 275, and is also set out in the Appendix (pp. A-12 to A-37).

JURISDICTION

The opinion and judgment of the court of appeals was entered on April 15, 1987, and was amended on June 25, 1987.

Petitioners' Petition for Rehearing and Suggestion for Rehearing En Banc was timely filed on April 29, 1987, and was denied on August 31, 1987 (App., p. A-11). This petition was timely filed within 90 days of that date (28 U.S.C. § 2101(c); Sup.Ct.Rule 20.4).

The jurisdiction of this Court to review the judgment of the court of appeals by writ of certiorari is conferred by 28 U.S.C. § 1254(1).

REGULATIONS INVOLVED

The pertinent provisions of the Income Tax Regulations dealing with the completed contract method of tax accounting in effect for the tax years in question are set out in the Appendix (pp. A-38 to A-55) (Income Tax Regs., § 1.451-3; 26 C.F.R. § 1.451-3 (April 1, 1985 Ed.)).

STATEMENT OF THE CASE

Through Walsh Construction Company ("Walsh"), a subsidiary and later, division of petitioner Guy F. Atkinson Company, petitioners had a 30 percent interest in the Water Tunnel Contractors ("WTC") joint venture. In 1970, WTC as the low bidder, entered a contract to construct a large, 13.7 mile underground "water tunnel" for the City of New York, designed to carry potable water for human consumption.

For federal income tax purposes WTC elected to report profits and losses from the water tunnel project under the "completed contract" method of accounting for the results of long-term contracts (CR 20, SF, ¶ 102).[1] The basic issue is whether, under the completed contract method, WTC was entitled to report its operating loss on the project, exceeding $97 million, in 1975, when all of WTC's work under the contract was unequivocally over, or whether that loss could be reported only in 1979, when

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[1] "CR" refers to the Clerk's Record in the court of appeals; "RT" to the transcript at trial; "SF" to the parties' Stipulation of Facts; and "JE" to the parties' stipulated exhibits.

the parties' outstanding contingent claims in litigation arising from the project were later resolved.[2]

1. The 1975 completion of WTC's work on the water tunnel project

Following full trial, the Tax Court found that by the end of 1975, WTC's physical performance of work on the project was completely over, and that both WTC and the City realized that fact (App., pp. A-16 to A-17, A-23). The Court found:

> "WTC management concluded that there was no reasonable likelihood that WTC would resume performance following the City's rejection of the October 15, 1975 [settlement] offer, and after November 1975, the management committee did not consider returning to work" (App., pp. A-16 to A-17).

Further:

> "WTC attempted to renegotiate the contract with the City, but by the end of 1975 negotiations had failed *and both WTC and the City realized that WTC would not resume*" (App., p. A-23) (emphasis added).

The record overwhelmingly supports these findings.

WTC commenced work on the project in February 1970. From the outset, it experienced significant delays and incurred expenses

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[2] WTC's loss was calculated by taking $143,069,160, constituting WTC's actual "gross receipts" from the project since its inception, and deducting $217,537,597, representing WTC's "costs of operations" on the project, and an additional $23,225,737, representing "project shutdown write-offs" (CR 20, SF, ¶¶ 105, 107). Petitioners deducted Walsh's distributive share (CR 20, SF, ¶¶ 105-106, 108-109).

If 1975 is ultimately determined to be the year of completion for tax reporting purposes, the Commissioner does not dispute WTC's "gross receipts" or "cost of operations" figures, which would produce a net deductible loss of $74,468,437 (App., p. 21). However, the Commissioner has disputed the deduction of certain of the items comprising "project shutdown write-offs" (ibid.). In view of its decision that tax reporting was improper in 1975, the court of appeals did not reach that issue (App., p. A-10).

far in excess of the payments provided under the contract (CR 20, SF, ¶ 48). In March 1973, WTC submitted a claim to the City for increased compensation and extended time for performance (CR 20, SF, ¶ 49). WTC claimed that the delays were due primarily to unstable rock conditions which had been deliberately misrepresented by the City; to the City's delays in issuing necessary work permits; to revisions of contract drawings; and to the City's unforeseen changes in and additions to the work (ibid.). By that time, WTC and its auditors had determined that WTC had been discharged from further performance by the City's material breaches of contract and misrepresentations (App., p. A-18; RT 78-79).

In response to WTC's claims, the City's Board of Water Supply ("Board") agreed in November 1974 to pay increased compensation to WTC under a proposed supplemental agreement which had to be submitted to the City's Board of Estimate. However, the Board of Estimate, which was at that time attempting to deal with the City's threatening financial defaults, refused to act on the proposed agreement. In view of this, and WTC's losses to date exceeding $100 million, WTC notified the Board in December 1974 that it was suspending operations on the Project (CR 20, SF, ¶ 58; JE 42-AQ). WTC commenced an action against the City and Commissioners of the Board in the United States District Court for the Southern District of New York, alleging misrepresentations and breaches of contract (CR 20, SF, ¶ 65).

In March 1975, in an effort to "buy time" to resolve their disputes, WTC and the Board executed an interim agreement regarding resumption of work on a cost reimbursement basis, and WTC temporarily resumed work on the water tunnel (CR 20, SF, ¶ 66). However, attempts to resolve the parties' differences ultimately proved unsuccessful. In July 1975, the interim agreement expired by its terms without a resolution of the dispute; consequently, WTC permanently ceased its productive operations on the water tunnel project (RT 24, 35; CR 20, SF, ¶ 68). The Board then declared WTC to be in default and directed it to surrender the tunnel, the construction sites, and all of the plant, equipment and supplies which WTC had provided for its work

(CR 20, SF, ¶ 70). In compliance with this directive, WTC surrendered the project to the City and withdrew from the construction sites; and the Board took possession (CR 20, SF, ¶ 73; RT 35-36). At that time, approximately 60 percent of the originally contracted for project was done (CR 24 at 7; CR 20, JE 70-BR, p. 2).

In September 1975, the City advised the District Court in the pending litigation that *"[t]he contractual relationship between plaintiffs and defendants is at an end."* The City declared further that *"plaintiffs [WTC] will not be doing further work on this project by Court order or otherwise"* (CR 20, JE 73-BU, p. 12) (emphasis added).

WTC performed no construction activity after July 1975 (CR 20, SF, ¶ 92). Aside from the liquidation of certain off-site equipment, its sole activity after being ordered off the project sites was the pursuit of the pending litigation (RT 42).[3] In June 1977, the City filed a counterclaim against WTC seeking recovery of some $369 million (CR 20, SF, ¶ 88).

After almost four more years of litigation, WTC and the City finally settled their outstanding claims in March 1979. The stipulation of settlement provided for the City's payment of $23.5 million to WTC, and for the release of each party's claims against the other (CR 20, SF, ¶ 90).

2. The completed contract regulations

The governing provision of the Income Tax Regulations, section 1.451-3, provides two alternative methods of tax accounting for profit or loss under long-term contracts, the "percentage of completion" method, and the "completed contract" method. In this case WTC elected to use the completed contract method.

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[3] In 1976, the City re-let a portion of the project to another contractor without objection by WTC pursuant to competitive bidding in which neither WTC nor any of its partners submitted bids (RT 137; CR 20, SF, ¶ 85).

Under the completed contract method, Income Tax Regulations section 1.451-3(d)(1) (App., p. A-42) provides that, except in cases to which the "dispute" provisions apply, "gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which such contract is completed * * * ." Further, *except in cases to which the dispute provisions apply*, Income Tax Regulations section 1.451-3(b)(2) (App., p. A-40) provides that "a long-term contract will not be considered 'completed' until final completion and acceptance have occurred."

Where, as in this case, however, there *are* disputes between the owner and the contractor on project termination, Income Tax Regulations section 1.451-3(d)(2), (3) and (4) (App., pp. A-42 to A-49) contain special "dispute" provisions under which tax reporting explicitly does not depend on "final completion and acceptance."

Instead, they require the reporting of gain or loss "*on or after a taxpayer tenders the subject matter of a long-term contract*" (Income Tax Regs., § 1.451-3(d)(2)(i), (3)(i) and (4)(i); App., pp. A-42, A-46, A-48) (emphasis added).

The basic concept of these regulations (with one exception not applicable in this case)[4] is to provide that in such cases, the

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[4] The one exception involves disputed claims by the *buyer*, i.e., owner (in this case, the City), which affect so much of the contract price that it is not possible to determine whether a profit or loss will ultimately be realized after the dispute is resolved, in which event reporting is deferred until the dispute is finally resolved (Income Tax Regs., § 1.451-3(d)(2)(ii); App., pp. A-42 to A-43). However, profit or loss is reportable at the termination of contract performance (the time of tender) to the extent that the taxpayer is assured of a profit or loss on the contract regardless of the outcome of the disputed buyer's claim (id., § 1.451-3(d)(2)(iii), (iv) and (v); App., p. A-43). (Contingent claims of the taxpayer, i.e., contractor (in this case WTC), are to be disregarded in determining the assured gain or loss.)

The "buyer's claim" exception to the requirement that gain and loss be reported in the tax year in which contract performance is over is not applicable in the instant case, because WTC was assured of a substantial

existence of outstanding disputes and litigation contingencies between the taxpayer (contractor) and the owner will *not* operate to defer the reporting of gain or loss. Instead, the results of operations are to be reported in the year of tender of the contract "subject matter"—in this case, 1975—without regard to the stage of completion of the project or the size of the contractor's claims. Any additional income or deductions resulting from the subsequent resolution of the parties' legal disputes is to be separately reported at that time (Income Tax Regs., § 1.451-3(d)(2), (3) and (4); App., pp. A-42 to A-49).

The regulations make clear that the existence of a disputed claim, such as WTC's claim against the City, at the time of tender of the contract subject matter does not operate to defer tax reporting. Gain or loss is to be reported in the tax year in which the "contract is completed (without regard to the dispute)" (id., § 1.451-3(d)(3)(ii); App., p. A-46; see also id., § 1.451-3(d)(2)(iii), (d)(2)(iv) and (d)(4); App., pp. A-43, A-48 to A-49).

This distinction between the time for reporting the results of completed operations, on the one hand, and the time for reporting the results of contingent litigation claims arising from such operations, on the other, is fundamental to the disposition of this

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loss without regard to the outcome of the City's claim (which was not even filed until 1977) against it. The City's success on that claim would simply have increased WTC's loss by another $369 million.

In the case of disputes arising from *taxpayer* claims for additional compensation, profit or loss is to be reported "in the taxable year the contract is completed (*without regard to the dispute*)" (id., § 1.451-3(d)(3)(ii); App., p. A-46 (emphasis added)) *in all cases*. Unlike the case of disputes from buyer claims, the taxpayer is required to report income and expenses in the year of tender of contract performance *even if the pendency of the taxpayer's contingent claims makes it impossible to determine whether a profit or loss will be ultimately realized on the job after all claims are resolved* (ibid.; see particularly § 1.451-3(d)(3)(v), Example (1); App., p. A-47).

In cases involving disputes from *both* taxpayer and buyer claims, the basic principles stated above are applied in combination (see id., § 1.451-3(d)(4)(i), (ii) and Examples (1)-(2); App., pp. A-48 to A-49).

case and reflects settled principles of tax accounting (infra, pp. 11-13).

3. The opinions below

Notwithstanding its finding that performance under the water tunnel contract was unequivocally over in 1975 (supra, p. 3), the Tax Court held that the contract could not be considered to be completed for tax reporting purposes on the theory that, in the case of a disputed midstream termination of work, the general "final completion and acceptance" standard of the completed contract regulations (§ 1.451-3(b)(2); App., p. A-40) could not be satisfied (App., pp. A-26 to A-28). The Tax Court recognized that the "dispute" provisions of the regulations are an express exception to the "final completion and acceptance" language, but held that they are applicable only in cases in which the work originally called for by the contract has been "substantially" completed (App., p. A-24).[5]

Although affirming the Tax Court's decision, the court of appeals rejected the "substantial completion" standard for

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[5] The Tax Court judge recognized that "[t]hese regulations do not specifically say that the contract must be substantially completed" (ibid.). He nevertheless erroneously reasoned that the *examples* to the regulations implicitly contain such a requirement (id. at A-24 to A-25). In fact, the examples contain no such requirement.

The trial judge further reasoned that the "dispute" provisions could not apply to a case of midstream termination of work because they would require the entire originally estimated price for all work called for under the contract (some $220 million) to be included in income in the year of completion, rather than the approximately $140 million actually due to WTC for the work actually performed (App., pp. A-25 to A-26). In the court's view this would lead to "an absurd result" because in 1975 WTC had completed about 60 percent of the work called for under the contract and was entitled to no more than that portion of the originally estimated price. However, the court misapplied the definition of gross contract price set out in the regulations. Properly applied to exclude prices for work not done, work which the parties have recognized that the contractor will never perform, and for which the contractor has no contractual right of payment, the "dispute" provisions produce an entirely reasonable and sensible result.

application of the dispute provisions on which that court had rested its decision. (For that reason, the court of appeals' attempted reliance on the principle of "deference" to Tax Court opinions (App., pp. A-3 to A-4) was misplaced.) The court recognized that it had previously "squarely rejected the [Tax Court's] notion that 'substantial completion' " (App., p. A-7) is the standard for tax reporting under the completed contract regulations in *E. E. Black Ltd. v. Alsup* (9 Cir. 1954) 211 F.2d 879, on the ground that standard would "import into the tax law an unwarranted and undesirable uncertainty" (id. at 880). Instead, the court relied on "general contract principles" (App., p. A-6) in concluding that the "final completion and acceptance" standard of the regulations (which applies where there are *no* outstanding disputes between the parties at the time the taxpayer's work on a project has been concluded) can be satisfied only if there has been a complete "discharge" of contractual obligations, either by full performance, or by final resolution of the parties' contingent claims by agreement or judicial decree. However, the court recognized that "[j]udicial interpretation of [the completion standard] in the context of the regulations at issue is scarce" (App., p. A-4), and that "[e]xisting cases provide little guidance" (ibid.).

The court of appeals then turned to the "dispute" provisions of the regulations, which apply to cases such as the present, in which there are outstanding disputes between the parties upon the termination of project work. The court reasoned that because the dispute provisions in terms apply "on or after a taxpayer tenders the subject matter" of a contract (supra, p. 6), resolution of the case should turn on the definition of "tender" (App., p. A-8). The court based its decision entirely on contract principles applicable to the definition of "tender" *for the purpose of determining whether a tender gives rise to a right to full performance from the other contracting party as a matter of contract law* (App., pp. A-8 to A-9). On this basis, the court concluded that the dispute provisions could not apply in the instant case, because WTC had not tendered the full, originally contracted-for project (ibid.).

REASONS FOR GRANTING THE WRIT

The regulations governing tax reporting under the completed contract method of tax accounting apply to the results of many defense and other substantial long-term contracts. Their proper interpretation thus involves a continuing and important issue of tax accounting. The regulations adopt a carefully balanced scheme that recognizes the difficulty of applying traditional accounting methods to long-term contracts, while at the same time minimizing the potential for disruption and manipulation of tax reporting.

The court of appeals' decision destroys this balance by effectively reading the dispute provisions of the regulations out of existence and leaving the way open for parties to contract disputes to control the accrual of their expenses and income through manipulation of their litigation and settlement strategies. The court's decision is both unprecedented and illogical, resting its departure from well-established tax accounting principles solely on the application of inapposite principles of contract law governing whether a party has been finally discharged from its contractual obligations.

I. THE DECISION OF THE COURT OF APPEALS CONFLICTS WITH THE LANGUAGE AND PURPOSE OF THE COMPLETED CONTRACT REGULATIONS

The court of appeals' decision effectively reads the "dispute" provisions out of the long-term contract regulations. By definition and by their terms, those provisions are addressed to, and permit tax reporting in, situations in which one or both parties claim that the other has *not* fully performed all of the originally agreed contract obligations. That is the essence of the "disputes" to which the regulations are addressed. In cases involving outstanding disputes over the adequacy of performance, the regulations require only that the contract "subject matter" be finally tendered to the owner in order to permit tax reporting, whether or not the parties agree that the tender is sufficient to discharge all of the obligations of the contract (Income Tax Regs., § 1.451-3(d)(2), (3) and (4); App., pp. A-42 to A-49). Yet, the court of appeals has held that the dispute provisions do

not govern such cases, because they cannot be applied unless a party has in fact tendered "full performance" as a matter of contract law. The result is that the dispute provisions have been rendered essentially meaningless.

Besides being an obvious misreading of the regulations, the decision of the court of appeals conflicts with fundamental tax accounting principles. As a general rule, tax accounting for income and expenses must be on a basis which best shows "the net result of all the taxpayer's transactions during a fixed accounting period * * *" (*Burnet v. Sanford & Brooks Co.* (1931) 282 U.S. 359, 363). As stated in *Sanford & Brooks*:

> "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practical to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation" (id. at 365).

Under the general rules of accrual tax accounting, items of income and expense actually received or incurred (such as WTC's receipts and expenses of contract work in this case) must be reported, while items which are contested or contingent are not reported until the later time when all events have occurred which definitely fix the liability or entitlement (*Commissioner v. John Thatcher & Son* (2 Cir. 1935) 76 F.2d 900, 902 (expenditures actually made on contract must be reported at time incurred despite dispute, later resolved against contractor, as to contractor's ultimate liability for the expenditures); Income Tax Regs., § 1.451-1(a) (claims for items of additional income which are contested are not properly accruable)). The existence of outstanding contingent claims in litigation does not operate to defer tax reporting of items of income and expense which are not contested.

Long-term contract methods of tax accounting are simply variations on the accrual method, which permit a limited departure from the general requirement of annual reporting. As an exception to the general rule, the limited deferral of tax reporting permitted by the completed contract method must be

confined by its purpose, requires some determinable accounting period to which income and expenses may meaningfully be attributed, and must be "capable of practical operation" (*Burnet*, supra, 282 U.S. at 365).

The percentage of completion and completed contract methods were adopted to account for the difficulties of matching expenditures and receipts under a continuing contract for purposes of accrual basis accounting. They simply permit the parties to the contract to postpone reporting gain or loss on the project during the operational period of the contract when the matching problem exists. However, when the parties' performance of the contract is unquestionably over, and the actual revenues and expenses of operation are known, there is no justification for further postponement of tax accounting. At that point, the need for tax reporting on a regular basis comes into play.

The Tax Court followed these principles in *A. S. Wikstrom, Inc. v. Commissioner* (1969) 28 T.C.M. 143, a leading case on the completed contract method. It emphasized that determining the year of tax reporting is, and must be, "a practical matter" (id. at 153). For that reason, the Tax Court held that to permit outstanding contingent claims such as those asserted in this case to prevent a long-term contract from being considered complete, even though the taxpayer's performance under the contract is unquestionably over, would permit a taxpayer to manipulate the year of tax reporting simply by asserting claims:

> "The result of such deferral of closing contracts under the completed contract method until settlement of all claims would be a bonanza to contractors with long-term contracts and a disaster to the collection of tax revenues" (id. at 153).[6]

The dispute provisions of the regulations are designed to prevent the manipulation warned against by the Tax Court by clearly providing that outstanding contingent claims do not

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[6] Although it appears that the contract work in *Wikstrom* was substantially complete, the court did not base its decision on that fact (see infra, pp. 18-19).

operate to defer tax reporting. The decision of the court of appeals in this case, which permits the indefinite deferral of tax reporting under the completed contract method while the parties hash out their various legal claims against each other, eviscerates this protection.

Thus, in this case, the amount admittedly payable by the owner (the City) under the terms of the contract for work performed up to the termination date has been established, as have the expenses incurred by the contractor (WTC) in performing the work. To extend long-term contract reporting during a period when the parties are merely pursuing disputed monetary claims is akin to matching apples and oranges— to mixing the prices stated in the contract for work performed with the claims of the contractor for quantum meruit recovery or damages; and to mixing the expenses of performing the work with the expenses of litigation.

Under a practical and logical construction of the completed contract regulations, recognition of contract payments and the expenses of project performance should not be postponed beyond the year when all work performed by the taxpayer under the contract is finished and turned over to the owner, merely because further recovery of non-contract revenues may be had as a result of taxpayer claims, or further losses may be incurred as a result of owner claims (see *Commissioner v. John Thatcher & Son* (2 Cir. 1935) 76 F.2d 900, 902; *A. S. Wikstrom, Inc. v. Commissioner* (1969) 28 T.C.M. 143, 153). The unwarranted extension of tax reporting endorsed by the court of appeals would convert the completed contract method into the "long-term litigation" method and improperly postpone the recognition of income and expense for job performance, sometimes far into future years, depending on the complexity of the litigation involved. The court's decision opens the door to taxpayer manipulation and abuse by making the timing of the entire profit or loss from project performance turn on whether a claim is asserted and when it is settled or dropped.

II. THE DECISION OF THE COURT OF APPEALS RESTS ENTIRELY ON AN INAPPOSITE DEFINITION OF CONTRACT "TENDER"

The court of appeals' construction of the dispute provisions as turning on whether there has been a tender of full performance sufficient to give a "right to full payment" by the other contracting party (App., pp. A-8 to A-9) as a matter of *contract* law improperly transposes contract principles which address an entirely different question into a regulation governing tax reporting where they plainly have no relevance. By definition, the "dispute" provisions of the regulations are addressed to situations in which the parties to the contract *dispute* whether the contractor has tendered sufficient performance to entitle the contractor to payment. Thus, in example 2 to § 1.451-3(d)(4) of the regulations (App., p. A-49) the buyer claims that $4 million in work on a $10 million contract which was called for by the contract has yet to be performed. Nevertheless, the example requires tax reporting in the year that work under the contract is finished, notwithstanding an outstanding dispute regarding the adequacy of that work which affects 40 percent of the contract price.[7]

Put plainly, to conclude, as the court of appeals has, that the dispute provisions cannot be applied *unless* the contractor has tendered the "full performance" called for by the contract sufficient to discharge all contractual obligations and entitle the contractor to "full payment" makes nonsense out of the regulations. (Presumably, the court did not mean to suggest that the dispute provisions apply only if the contractor's disputed position is ultimately vindicated.)

If the court of appeals' approach to this problem were accepted, the question of tax reporting under the dispute provisions would

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[7] Another example also illustrates this point. In the case of example (5) under Income Tax Regs. § 1.451-3(d)(2) (App., pp. A-45 to A-46), dealing with disputes from buyer claims, when the taxpayer "finishes construction" of the building under a $1 million contract, the owner claims that almost $160,000 of work (equal to 16 percent of the contract price) must be done to comply with contract specifications.

become completely unworkable. The issue as to whether a contract was "completed" would require full litigation in the Tax Court of the underlying contract dispute between the contractor and the owner in order to determine whether the contractor in fact had tendered full performance. It is obvious that this would be unacceptable.

The facts of this case vividly illustrate the problem. Commencing as early as 1973, WTC took the position that it had been completely discharged from further contract performance by the City's misrepresentations and breaches of contract (supra, p. 4). Thus, if contract "discharge" were the standard for tax reporting, as the court of appeals holds, it would have been necessary for the Tax Court to undertake to retry the massive and complex underlying contract dispute between WTC and the City.

The Tax Court properly recognized that this could not be the standard for tax reporting. It therefore did not undertake to resolve whether WTC had been discharged from further performance by the City's misconduct, and whether it therefore had rendered the "full performance" that was contractually "due." The Tax Court made no findings that WTC was to blame, or that the City had not committed fraud and material breaches of contract which discharged WTC from further performance. It correctly found that "[t]he parties *disputed* the questions of whether WTC or the City was responsible for these delays and whether the City should bear the additional expense that WTC incurred in constructing the tunnel" (App., p. A-14) (emphasis added).

On appeal, the court of appeals nevertheless asserted, without the slightest support in the record or in the findings of the trial judge, that "WTC bolted its half-finished handiwork" (App., p. A-5) and "Atkinson did not manifest to the city any belief that it had discharged its obligation by performance" (ibid.). These statements are simply and demonstrably untrue. The end of work of the water tunnel project came as a result of the parties' *mutual* inability to resolve their lengthy dispute as to who was at fault, and not as a result of any "abortive performance" by WTC as the

court of appeals improperly states (id. at A-6).[8] The record provides no support for the prejudicial implication that WTC was to blame for the final, mutually agreed termination of work on the water tunnel. The Tax Court correctly thought that issue to be irrelevant and, accordingly, did not address it.[9]

As the Tax Court recognized, the regulations clearly do not require litigation in the Tax Court of the parties' underlying contract dispute, and whether the taxpayer was discharged cannot be the standard for establishing when tax reporting was proper. Where, as the Tax Court found was the case here, both parties are in agreement that work under the contract is unequivocally over (supra, p. 3), the regulations provide that tax reporting is not postponed by the parties' resort to litigation to determine who was at fault for the termination. By focusing on the question of contract discharge, the court of appeals misread the regulations and created a standard that is contrary to both sound tax principles and sound judicial administration. At the very least, the

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[8] The pertinent contract law principle is that stated by Professor Williston:

> " 'When a contract is broken in a material respect, the injured party is accorded a choice of remedies. He may treat the contract *at an end* and sue for the breach, or he may continue the contract in operation despite the beach * * * ' " (5 Williston on Contracts (3d Ed. 1961) § 700, p. 364) (emphasis added).

That is precisely what occurred here. Both WTC and the City believed that the other had materially breached the Water Tunnel contract, and in 1975 they mutually elected not to continue the contract, but to "treat the contract at an end," retaining their respective damages claims against each other.

[9] The court of appeals' claim that it "borders on the frivolous" to claim that the Tax Court did not find that WTC's termination of work was "unilateral" (App., p. A-6, n. 6), entirely misses the point. Obviously, WTC decided to stop work on the project in view of the City's material breaches of contract. The essential point which the court of appeals disregards, however, is that the Tax Court quite clearly did not undertake to resolve the contract dispute between the parties, and it made no finding that WTC had not been completely discharged from further performance by the City's material breaches of contract and misrepresentations as a matter of contract law.

court erred by depriving WTC of an opportunity to prevail even under the court's new theory by not remanding the case for evidence on the question whether the City's material breaches had discharged WTC's obligations under the contract (*Helvering v. Gowran* (1937) 302 U.S. 238, 247 (taxpayer is entitled to a remand to have an opportunity to present evidence that might affect result under new theory adopted for first time on appeal)).

Although the matter is by no means clear, the court of appeals also appears alternatively to suggest that the standard may be whether the contractor "insists" that it has fully performed, whether it has actually done so or not (App., p. A-9). Of course, this standard would be inconsistent with the court's lengthy, previous discussion of contract law, to the effect that a "tender" can occur only if the contractor *has in fact* fully performed. However, if the "insists" standard is the one the court meant to adopt, it would have required tax reporting no later than 1975 in this very case: *The record is undisputed that as early as 1973, WTC "insisted" that it was completely discharged from further contract performance because of the City's material and continuing breaches of contract* (supra, p. 4). Thus, if this is the standard, WTC complied. However, the "insisted full performance" standard cannot possibly be the standard for tax reporting, because it would make tax reporting turn on the subjective intentions of the taxpayer, as opposed to an objective standard which involves termination of performance and surrender of the project to the buyer.

The short of the matter is that the court of appeals' decision makes the "dispute" provisions essentially incomprehensible because:

(1) the court does not adopt the uncertain and discredited "substantial" completion standard, which was the *sole* basis for the Tax Court's decision;

(2) the "full performance in fact" standard which the court appears at one point to adopt, is irreconcilable with the purpose and plain language of the dispute provisions, which by definition are addressed to cases in which "full performance in fact" has *not* occurred; and

(3) the subjective "insisted full performance" standard alternatively suggested by the court of appeals' opinion is unsupported by any authority and is unworkable in the tax reporting context.

The court's opinion thus fails to state an understandable or workable concept of what "tender" under the dispute provisions means and throws tax reporting under the completed contract regulations into a state of confusion.

III. THE DECISION OF THE COURT OF APPEALS IS IN CONFLICT WITH OTHER DECISIONS CONSIDERING THE EFFECT OF OUTSTANDING CONTINGENT CLAIMS ON TAX REPORTING UNDER THE COMPLETED CONTRACT REGULATIONS

The court of appeals' conclusion that final completion and acceptance cannot be found for tax reporting purposes where there are unresolved claims following a mutually agreed work stoppage is also in conflict with the reasoning of a number of leading cases, decided prior to the addition of the "dispute" provisions, construing the general "final completion and acceptance" standard of the regulations (see *National Contracting Co. v. Commissioner* (1938) 37 B.T.A. 689, affirmed (8 Cir. 1939) 105 F.2d 488; *A. S. Wikstrom, Inc. v. Commissioner* (1969) 28 T.C.M. 143; and *C. H. Leavell & Co. v. Commissioner* (1969) 53 T.C. 426). In each of those cases, outstanding contingent claims at the time the taxpayer's work under the contract terminated prevented the contract from being "completed" in the *contractual* sense of final resolution of the parties' claims by full performance, agreement or judicial decree. In *Wikstrom* and *Leavell*, the originally contracted work appears to have been substantially completed. However, contrary to the court of appeals' misstatement (App., p. A-4), that was not the case in *National Contracting*. In *National Contracting*, just as in this case, work under the contract had been terminated mid-stream. In each of those three cases, the court focused on when the contractor's performance of *work* was over (not on whether the contractor had rendered "full performance"). And in each case, the court correctly applied settled accrual principles of tax

accounting to hold that income and expenses must be reported when a taxpayer's performance of work under a long-term contract was finally over (as was found by the Tax Court to have occurred in this case in 1975) notwithstanding the existence of outstanding, unresolved contingent claims which prevented the contract from being finally "discharged" as a matter of contract law.

CONCLUSION

For the reasons stated, this Court should grant this petition for a writ of certiorari.

Respectfully submitted,

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[Appendices follow]

Appendix A

Guy F. Atkinson Company of California and Subsidiaries,
Petitioners-Appellants,

v.

Commissioner of Internal Revenue Service,
Respondent-Appellee.

No. 85-7715.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted Dec. 10, 1986.
Decided April 15, 1987.
As Amended June 25, 1987.

Petition to Review a Decision of the Tax Court of the United States.

Before Kennedy, Tang and Thompson, Circuit Judges.

Tang, Circuit Judge:

Guy F. Atkinson Co. ["Atkinson"] appeals from a determination by the United States Tax Court of a $4,115,981 tax deficiency. We have jurisdiction under 26 U.S.C. § 7482. We affirm.

Facts and Proceedings:

Atkinson's subsidiary, Walsh Construction Co., was managing partner in a joint venture, Water Tunnel Contractors ["WTC"][1]. WTC was organized to construct a water tunnel for New York City. WTC submitted winning bids approximating $222 million for the contracts related to the water tunnel project. In its 1970 federal partnership income tax return, WTC elected to report income and expenses arising from the project under the completed contract method of accounting as set forth in the

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[1] Atkinson filed consoldiated income tax returns with its subsidiaries during the calendar years 1972 through 1975. WTC filed federal partnership income tax returns for the years 1970 through 1975.

Treasury Regulations. Under this method of accounting, all income and expenses derived from a long-term contract are reported only in the year in which the contract is completed, permitting reporting of income and expenses on a transactional rather than an annual basis. "Completion" of a long-term contract occurs upon final completion and acceptance. Where disagreement arises as to completion, "dispute" provisions provide for reporting of gain or loss on or after the taxpayer "tenders" the subject matter of the long-term contract. *See* Treas.Reg. § 1.451(d)(2),(3),(4).

WTC began work in February 1970 and immediately experienced significant delays and expenses in excess of payments provided for in the contract. The parties executed modifications to the contract in November 1973 and July 1974. Pursuant to these modifications, WTC conveyed title to and liens on its plant, facilities and equipment which were located at the project sites to the city as security for performance. Because of a dispute in December 1974, WTC suspended all operations except pumping and guard services. It resumed work under an interim agreement in 1975 for four months. With less than 60% of the tunnel finished, WTC ceased all work on July 7, 1975 and on July 9, 1975 was declared in default by the city. On July 14, 1975, WTC surrendered possession of all its property on the sites.

On July 28, 1975, WTC filed for injunctive relief in U.S. District Court. In opposing the motion, the city stated that its contractual relationship with WTC was at an end and that WTC would not be doing further work on the tunnel project. Settlement attempts in the fall of 1975 bore no fruit, and WTC apparently decided against returning to work following the city's rejection of a settlement offer in November 1975. The city, without objection from WTC, re-let a portion of the contract to another joint venture. In an amended complaint filed in Septmber 1975, WTC sought, inter alia, quantum meruit recovery for all work performed and money expended or, in the alternative, damages for breach of contract amounting to $205 million. The city's

counterclaim, filed in June 1977, alleged breach of contract and sought damages amounting to $369 million.[2]

On its partnership returns for the years 1974 and 1975, WTC claimed deductions for losses it had incurred on the project. The Commissioner disallowed the claimed deductions ruling that the contract had not been "completed" in either of those years. Even assuming 1975 was a proper year for deducting losses, the Commissioner determined that certain items deducted as "project shutdown costs" were not deductible.[3] Upon appeal, the Tax Court found in favor of the Commissioner, holding that the termination of contract work after less than 60% of the work was performed was not "final completion and acceptance" so as to permit reporting of income and losses in either 1974 or 1975. The Court reasoned that WTC had neither performed its obligations nor modified them by 1975. The Court reasoned further that the dispute provisions did not apply with respect to contracts which have not been "substantially completed." The Court concluded that where the dispute provisions do not apply, reporting of gain or loss must be deferred until such time as the taxpayer can determine whether the contract will result in a net gain or net loss. Finally, the Tax Court found for the Commissioner on the non-deductibility of the project shutdown costs.

DISCUSSION:

The issues in this case present mixed questions of law and fact subject to review de novo by this Court. *See United States v. McConney*, 728 F.2d 1195, 1202 (9th Cir.), *cert. denied*, 469 U.S. 824, 105 S.Ct. 101, 83 L.Ed.2d 46 (1984). We note, however, that the Commissioner has latitude in the interpretation of the Internal Revenue Code, and that the Tax Court's opinions

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[2] The parties ultimately settled in 1979. By the terms of the agreement, the city paid $23.5 million to WTC and rescinded its declaration of default, and the parties released all claims against each other.

[3] These items included certain inventories seized by the city, materials purchased but not yet installed, and future receivables under the contract.

bearing on the Internal Revenue Code are entitled to deference because of its special expertise in the field. *Take v. Comm'r,* 804 F.2d 553, 556 (9th Cir.1986).

1. Atkinson's Work Stoppage and the City's Taking of Possession Did Not Amount to Final Completion and Acceptance for the Purposes of § 1.451-3(d)(1)

Treasury Regulation section 1.451-3(d)(1) states that, for taxpayers who elect the completed contract method, income and expenses arising from a long-term contract must be reported in the taxable year in which the contract is "completed."[4] A long-term contract is considered "completed" upon "final completion and acceptance." Treas.Reg. § 1.451-3(b)(2). Judicial interpretation of these terms in the context of the regulations at issue is scarce. Existing cases provide little guidance, as they assume performance of all the work specified in the contract, or something close. *See A.S. Wikstrom, Inc. v. Commissioner,* 28 T.C.M. 143, 152 (1969); *National Contracting Co. v. Commissioner,* 37 B.T.A. 689, 701 (1983), *aff'd,* 105 F.2d 488 (8th Cir. 1939). Contrary to Atkinson's suggestion, these cases are not persuasive authority in the circumstances of this case, where performance is far less extensive. Accordingly, we turn to related regulations and general principles of contract law for

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[4] Treas.Reg. § 1.451-3(d)(1) states in pertinent part:

> Completed contract method—(1) In general. Except as otherwise provided in paragraphs (d)(2), (3) or (4) (relating to disputes) of this section, under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which such contract is completed (as defined in paragraph (b)(2) of this section). All costs properly allocable to a long-term contract (determined pursuant to paragraph (d)(5) or (6) of this section) must be deducted from gross income for the taxable year in which the contract is completed. In addition, account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion.

guidance in interpreting the phrase "final completion and acceptance".[5] The regulations do not apply to the tax year in question, and are therefore not binding; they do, however, shed light on the meaning of "final completion and acceptance," making them a useful tool in our analysis.

The clear import of the regulations is fatal to Atkinson's claim that its abandonment of the project, and the city's taking of possession of the sites and property, amounts to "final completion and acceptance."

The parties here hardly behaved in a way as to indicate completion and acceptance. WTC bolted its half-finished handiwork; the city declared default, and later sued for breach of contract. Atkinson did not manifest to the city any belief that it had discharged its obligation by performance. Nor did the city indicate assent to acceptance of WTC's abortive efforts as performance entitling it to payment.

The city re-let portions of the contract to other contractors, without objections from Atkinson, in order that more than 40% of the water tunnel project could be completed. Clearly, more than a few last nails remained to be driven.

Familiar contract principles also refute Atkinson's claim that "final completion and acceptance" occurred. The city's only use

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[5] Treas.Reg. § 1.451-3(b)(2)(B) states that facts and circumstances to be considered in determining whether final completion and acceptance have occurred include:

> . . . [t]he manner in which the parties to the contract dealt with each other and with the subject matter of the contract, the physical condition and state of readiness of the subject matter of the contract, and the nature of any work or costs remaining to be performed or incurred on the contract. In considering the manner in which the parties deal with the subject matter of the contract, any use of the primary subject matter of the contract by the purchaser (except for testing purposes that produce no gross revenue, cost savings, or other substantial benefits for the purchaser) will be considered.

of the incomplete tunnel related to the re-letting of the unfinished work to other contractors.

Reference to general contract principles reinforces our analysis under § 1.451-3(b)(2)(i)(B). Completion and acceptance contemplate discharge by performance of the contractual obligation, and consequent severance of the relationship between the parties. *See* 5A A. Corbin, Corbin on Contracts § 1245 at 578-580 (1964). One learned commentator has aptly described the effect of defective performance for the purpose of analyzing whether such performance may result in discharge:

> The mere receipt of [a] defective performance is not in itself sufficient to discharge [a] claim to damages for the breach. There must be an expression of assent to accept it in satisfaction and as a complete discharge. . . . [T]he [obligee] must be aware of the performance that is being tendered or that has been rendered and he must express his assent to accept it as a complete discharge of the obligor's duty to him.

Id.

As discussed above, nothing in the facts of this case indicates assent by the city to accept the abortive performance of WTC as a "complete discharge" of WTC's duty. On the contrary, the city took possession of the product of WTC's defective performance, declared default, and sued for breach of contract.

We decline to lend to the Treasury Regulations an interpretation which would permit unilateral work stoppage and the taking of possession by the b[illegible]er to circumvent the completed contract method.[6] Under the [illegible]egulations, as well as under principles of contract law, there is no indication the sequence of events in issue amounted to "final completion and acceptance." In the past, this Court has strictly construed the term

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[6] The Tax Court found that termination of the contract was "unilateral," and that finding is plainly supported by the evidence. Atkinson's claim that the Tax Court did not so find borders on the frivolous, given its earlier claim that "in the court's view, WTC's termination was 'unilateral.' "

"completed" as used in the regulations and has squarely rejected the notion that "substantial completion" satisfies the regulations' completion requirement. *E.E. Black, Ltd. v. Alsup,* 211 F.2d 879, 880 (9th Cir. 1954) (construction of building without installation of thermostats did not amount to "completion" within meaning of regulation). We reiterate that construction today. Absent completion, only upon final resolution of the parties' claims by agreement or by authoritative decree can there occur termination of the contractual relationship as contemplated by the regulations. Accordingly, we proceed to evaluate whether the "dispute provisions" make inapplicable the requirement of final completion and acceptance as set forth in § 1.451-3(b)(2).

2. The "Dispute Provisions" of the Treasury Regulations Are Inapplicable, thus Prohibiting Atkinson from Deducting Claimed Losses in 1975

Atkinson contends that WTC "tendered" the water tunnel, and thus that the "dispute provisions"[7] of the Treasury Regulations permit reporting of loss in 1975, the year in which Atkinson was

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[7] The "dispute" provisions provide an exception to the completed contract method. Subparagraph (2), which governs disputes over buyer claims, provides for the reporting of income and deductions in the year in which the dispute is resolved.

Subparagraph (3) governs disputes over taxpayer claims and provides for reporting of income in the year in which the dispute is resolved. Deductions occurring subsequently to completion are deducted in the years in which incurred.

Subparagraph (4), which we consider most applicable to this case, governs contracts with disputes over claims from both buyer and taxpayer. It provides as follows:

> (4) Contracts with disputes from both buyer and taxpayer claims. (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract, a dispute exists involving both claims by the taxpayer for an increase in the contract price and claims by the other party to the contract either for a reduction in the contract price or for the performance of additional work under the contract. In any case described in the preceding sentence, principles similar to the principles of subparagraphs (2) and (3) of this paragraph shall be applied.

declared in default and surrendered the premises and property. Atkinson emphasizes the city's demand and WTC's compliance therewith to surrender the tunnel, and the city's stated position in 1975 that WTC would not be doing further work on the project. We disagree.

Resolution of this issue focuses on the definition of "tender." The regulations are silent. Accordingly, we turn to general principles of contract law. *Cf. Isbrandtsen Co. v. Johnson,* 343 U.S. 779, 783, 72 S.Ct. 1011, 1014, 96 L.Ed. 1294 (1952); 2A N. Singer, *Statutes and Statutory Construction* § 50.01 at 421-22 (4th ed. 1984). Professor Williston has defined tender as an offer to perform an obligation, coupled with the present ability to so perform, so that absent the refusal to cooperate by the party to whom the tender is made, the obligation would be immediately satisfied. 15 S. Williston, Williston on Contracts § 1808 at 418 (1972). Courts and commentators have applied the term "tender" to both the obligation to pay money and the transfer of property. The essential requisites of tender are:

> (1) An unconditional offer to perform, coupled with a manifested ability to carry out the offer;
>
> (2) A production of the subject matter of the contract;
>
> (3) The property tendered must not be less than what is due; and
>
> (4) If greater, there must be no demand for a return of the excess.

Id. § 1810 at 421-22.

Tender gives a right to performance from the other party, or to an action for damages against that party. Thus, tender may operate to discharge the contractual obligation. *Id.* § 1809 at 419-20. *See Monroe Street Properties, Inc. v. Carpenter,* 407 F.2d 379, 380 (9th Cir. 1969).

WTC's abandonment of the work sites was anything but a "tender" of the subject matter of the contract. WTC lacked the ability to perform, in the sense that its financial distress disabled it from any activity after 1975 except the conduct of litigation. Nor

did the property which was abandoned by WTC and seized by the city—a half-finished water tunnel—approximate what was due under the contract. Were we to accept such a proposition, it would follow that WTC's "tender" of a half-finished water tunnel gave it the right to full payment, or an action for damages for the full contract price, against the city. That would be an absurd result.

Our conclusion is guided by contract principles but finds further support in the examples set forth in illustration of the dispute provisions. The examples assume, with one exception, that the taxpayer has "finishe[d] construction." The disputed items in the examples include the wrong sort of paint on bridge girders, ex. 2 to § 1.451-3(d)(2), a defective elevator in a manufacturing plant, ex. 3 to § 1.451-3(d)(2), defects in heating and electrical systems in a building, ex. 2 to § 1.451-3(d)(3), and location and workmanship of heating ducts, ex. 1 to § 1.451-3(d)(4). In only one example does Atkinson find potential support for the proposition that a dispute of the magnitude of its half-finished water tunnel is a proper case for application of the dispute provisions. That example, ex. 2 to § 1.451-3(d)(4), involves a builder, R, who "tender[s]" an office building to X. X finds "certain aspects" of the construction so unsatisfactory that he demands an additional $4 million worth of work on the $10 million contract. Atkinson contends that the example implicitly hypothesizes an office building only 60% complete, and reasons that its predicament is so analogous as to trigger the dispute provisions. We disagree. The example does not embody an arithmetic formula which purports to calculate whether tender has occurred based upon the amount of money in dispute. Instead, the example contemplates an obligor who insists that it has fully performed and who delivers his product for acceptance. Such a scenario hardly encompasses the abandonment of a slightly more than half-finished tunnel and subsequent seizure of the subject matter of the contract. We do not read the language of the Treasury Regulations, construed in light of contract law principles, to dictate such a result.

3. The "Project Shutdown Costs" Were Not Properly Deductible in 1975

Atkinson contends that Treas.Reg. § 1.451-3(d)(1)[8] permits deduction of its "project shutdown costs" as costs properly allocable to the contract. Affirmance of the Tax Court on the completion issue renders unnecessary an extended discussion of the merits of this issue. The contract was simply not completed, as required by § 1.451-3(d)(1), in 1975. The materials at issue were not installed in 1975, but "remain[ed] on hand." Inventories and future receivables should not be included in the cost of the contract; they were "leftovers." The regulations adopt the quite sensible approach of awaiting final resolution of the dispute, when a gain or loss on the items claimed will finally emerge. *See* Treas. Reg. § 1.451-3(d)(2)(i) (deductions taken in year in which dispute is finally resolved).

CONCLUSION:

The Tax Court correctly concluded that, in viewing all the facts and circumstances, Atkinson's work stoppage and the city's taking of possession did not amount to final completion and acceptance for the purposes of Treas.Reg. § 1.451-3(d)(1). The Tax Court was also correct in its conclusion that Atkinson's abandonment of the work sites with less than 60% of the job completed failed to satisfy the requirement of "tender," thereby precluding applicability of the disputes provisions of the Treasury Regulations. Our holding on the issue of completion requires affirmance of the Tax Court as to deductibility of the project shutdown costs.

Affirmed.

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[8] § 1.451-3(d)(1) reads in pertinent part:

> All costs which are properly allocable to a long-term contract . . . must be deducted from gross income for the taxable year in which the contract is completed. In addition, account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion.

Appendix B

United States Court of Appeals
for the Ninth Circuit

NO. 85-7715
Tax Ct. # 8750-81

Guy F. Atkinson Company of California and Subsidiaries,
Petitioners-Appellants,

v.

Commissioner of Internal Revenue Service,
Respondent-Appellee.

Order Denying Petition for Rehearing & Suggestion for Rehearing En Banc

[Filed Aug. 31, 1987]

Before: Kennedy, Tang and Thompson, Circuit Judges.

The panel as constituted above has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

Appendix C

82 T. C. No. 24

United States Tax Court

Guy F. Atkinson Company of California and Subsidiaries, Petitioners

v.

Commissioner of Internal Revenue, Respondent

Docket No. 8750-81.

Filed Februrary 16, 1984.

STERRETT, *Judge:* By notice of deficiency dated March 5, 1981, respondent determined deficiencies in petitioners' Federal income taxes as follows:

Taxable year ended Dec. 31,	Deficiency
1972	$ 758,074.00
1973	15,368.00
1974	5,290.00
1975	3,414,988.00
	$4,193,720.00

After concessions, the issues for decision are whether the proper year for reporting losses from the construction of a water tunnel where the contractor elected the completed contract method of accounting was 1975 or an earlier year and, if so, whether certain losses were allowable in the year of completion. The other issue for decision is whether one of the petitioners was a Western Hemisphere Trade Corporation in 1975.

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

The petitioners are the Guy F. Atkinson Company of California (hereinafter GFA Co.), a California corporation, and subsidiary corporations which joined in the filing of consolidated returns for the calendar years 1972 through 1975. GFA Co.'s principal place of business was in South San Francisco, California at the time the

petition was filed. GFA Co. and its subsidiaries filed consolidated United States Corporation Income Tax Returns (Forms 1120) for the calendar years 1972 through 1975 with the Internal Revenue Service Center, Fresno, California.

I. Losses From the Water Tunnel Project.

FINDINGS OF FACT

During the years at issue the Guy F. Atkinson Company (hereinafter Atkinson), a Nevada corporation, one of GFA Co.'s wholly owned subsidiaries, owned the Walsh Construction Company (hereinafter Walsh), as a subsidiary. On December 31, 1970, Walsh merged into Atkinson becoming a division of Atkinson for the remaining years at issue.

Walsh was the sponsoring and managing partner of the Water Tunnel Contractors (hereinafter WTC), a joint venture organized to construct a water tunnel (hereinafter the Tunnel Project) for the New York City (hereinafter City) water supply system. Walsh's interest in the profits, losses, and capital of WTC as of December 18, 1969, was 30 percent.

WTC filed United States Partnership Income Tax Returns for the calendar years 1970 through 1975 with the Director, Internal Revenue Service Center, Holtsville, New York, and the Director, Internal Revenue Service Center, Fresno, California.

During the years at issue, the Board of Water Supply of the City of New York (hereinafter the Board) was a City agency responsible for developing the City's sources of water. The final authority respecting the use, development and improvement of City land rested with the Board of Estimate (hereinafter BOE). Before the City could undertake capital projects, the BOE had to approve the standards, scope, and final designs of such projects.

On January 15, 1970, the Board awarded three contracts (520, 521, 522) to WTC as low bidder for the construction of the first stage of a water tunnel. WTC treated these contracts and the Formal Change Orders thereto as parts of a single contract for financial accounting and tax reporting purposes.

These contracts required the excavation and construction of about 13.7 miles of concrete-lined pressure tunnel, 25 access shafts, 3 large underground caverns (valve chambers) and related work. The contracts contained lump-sum items and unit price items. The lump-sum items included those items such as the construction of certain shafts for which WTC bid a fixed amount. The unit price items were those for which WTC bid a certain price per unit of material installed or work performed such as per pound of structural steel installed. WTC's bid was thus a summation of prices for many items. For the three contracts, the bid totaled $228,605,810, less a discount of 2.63 percent if WTC received all three contracts, or $222,593,477.20.

Before receiving bids the Board issued documents to prospective bidders which contained estimates of the quantities of unit price items which the tunnel required. The documents indicated, however, that the bidders bore the obligaiton of substantiating these estimates and of bidding accordingly. Furthermore, the documents warned that the city would not pay an amount in addition to the total bid in the event the Board underestimated the quantity of any item. The final contract incorporated the estimates of and amounts bid for each item. Under the terms of the contract, structural steel support was a separate unit price item, and the Board estimated that the tunnel would require a total of 700,000 pounds of steel.

On February 6, 1970, the Board gave WTC notice to start constructing the tunnel, and WTC began working on the tunnel that month. WTC immediately experienced significant delays and incurred expenses in excess of payments provided for in the contract.

The parties disputed the questions of whether WTC or the City was responsible for these delays and whether the City should bear the additional expense that WTC incurred in constructing the tunnel. Eventually, WTC installed structural steel in an amount far in excess of the estimate of 700,000 pounds, and incurred costs far in excess of the amount the City was willing to pay. In point of fact, by December 6, 1974, WTC had installed 18,543,182 pounds of structural steel, and of this amount, the Board refused to approve or pay for 3,408,572 pounds.

WTC informed the Board that its projected costs in building the tunnel exceeded its projected revenues under the Contract, and WTC and the Board entered two agreements modifying the Contract on November 8, 1973 and July 22, 1974. Under these agreements the Board agreed to release a total of $7,200,000 of the retained percentages, which were amounts that the City had withheld from the progress payments as per the Contract in order to assure WTC's performance, and to advance an additional $3,000,000 to WTC. In addition, WTC conveyed title to and liens in its construction plant, equipment and facilities which were located or used at the tunnel construction sites to the City as security for the performance of the Contract.

On November 9, 1974 the Board and WTC agreed to a proposed supplemental agreement concerning the Tunnel Project, which the BOE never approved. Since the BOE did not approve the supplemental agreement at its December 5, 1974 meeting, WTC suspended all tunneling, excavation and support operations, but continued to provide pumping and guard services at the construction sites. As a result of an Interim Agreement dated March 10, 1975, between WTC and the Board, WTC agreed to resume work on the tunnel for four months. The Interim Agreement provided the scope of the work WTC would complete in this period, and the City agreed, *inter alia*, to pay WTC the costs incurred for work performed during this period. The agreement preserved the existing rights of both WTC and the City. WTC agreed to suspend prosecution of its legal action until 20 days after the expiration of the Interim Agreement, and the Board agreed not to declare WTC in default during the terms of the agreement.

On May 19, 1975, Jacobs Associates, a firm which the City had hired as a consultant on the Tunnel Project, submitted a report which estimated that WTC could complete the tunnel for a cost of $264,079,892 and that another contractor could complete the project for $298 million. These figures excluded an allowance for profits. WTC's estimate for completing the tunnel at the time was about $370 million. A period of unsuccessful negotiation concerning completion of the Tunnel Project ensued between WTC and the City.

Since WTC and the City had failed to resolve their differences when the Interim Agreement expired, on July 7, 1975 with less than 60 percent of the Tunnel Project finished, WTC ceased all tunneling, excavation and support operations, but continued to provide security and maintenance. On July 9, 1975, the Board declared WTC to be in default and directed WTC to discontinue pumping and guard services and to surrender possession of the tunnel, shafts, chambers, construction site, materials, plant equipment, supplies, and all property WTC provided for the purposes of the Contract. WTC complied with this request on July 14, 1975, but protested the declaration of default. Following the abandonment of the sites, WTC moved all of its documents from New York to Connecticut and discharged all union personnel and most of the salaried personnel working on the tunnel. At that time, WTC personnel expressed the concern over losing the property which the City possessed pursuant to the default declaration. WTC was also concerned that the declaration would preclude members of the WTC joint venture from bidding on future work, as well as injure their credit.

On July 28, 1975, WTC filed a motion in the District Court for the Southern District of New York seeking a preliminary injunction rescinding the declaration of default and restraining the City from taking any action other than providing maintenance and insurance for the Tunnel Project and reletting the Contract. Although WTC specifically stated that it did not want to prevent the City from reletting the Contract, the City was concerned that a recision of its default declaration would have that effect.

Thereafter WTC maintained that it was entitled to compensation for the assets which the City had possessed and insisted that the City maintain the equipment and consult WTC before selling any of the items. WTC further insisted that it be named insured under policies covering the Tunnel Project assets.

Settlement attempts involving WTC's resumption of work on the contract continued through the summer and fall of 1975 without success. The WTC management proposed a settlement offer on October 15, 1975, which offer was rejected. Although WTC's lawyers may have contemplated the idea of WTC's resumption of performance as late as April 1976, the WTC

management concluded that there was no reasonable likelihood that WTC would resume performance following the City's rejection of the October 15, 1975 offer, and after November 1975, the management committee did not consider returning to work. The City, in motion papers dated September 12, 1975, stated that "[t]he contractual relationship between [WTC] and [the City] is at an end ***." The City further stated "[WTC] will not be doing further work on this project by Court order or otherwise." On November 17, 1976 the City let Contract 520A which covered a portion of the work specified in the original Contract to another joint venture. Neither WTC nor any of its members submitted bids for this contract.

In its amended complaint dated September 9, 1975, WTC sought damages in the amount of $205 million arising from the excessive unanticipated costs it encountered in constructing the tunnel. In addition, it sought a recision of the default declaration, and the return to WTC of all property belonging to WTC which the City had seized in connection with the default declaration, or the payment of compensation for this property. WTC was seeking compensation for this property as late as June 14, 1976. On July 28, 1976, the United States District Court for the Southern District of New York denied WTC's request for a preliminary injunction. On January 18, 1977, WTC filed a second amended complaint which sought, *inter alia*, $217 million in damages or quantum meruit recovery, and recovery for all equipment, materials or other property belonging to plaintiff and seized in connection with the default declaration.

The City in its answer to the second amended complaint dated July 13, 1977, asserted a counterclaim seeking a total of $369 million. The attorneys representing the City felt that if the parties proceeded to trial in this litigation, the City might suffer a liability of as much as $100 million.

Finally, on March 1, 1979, WTC and the City settled. The City paid $23,500,000 to WTC and rescinded its default declaration. The parties released all claims against each other arising from the Contract and Interim Agreement.

For financial accounting purposes, WTC reported revenue and expenses attributable to the construction of the Tunnel Project on the percentage of completion method until March 31, 1973. At that time, the WTC management decided to change their accounting method for financial accounting purposes because of the excessive losses WTC was suffering. Following March 31, 1973, costs were recognized to the extent the City reimbursed them. The excess of costs over payments for this period was carried as an asset. Thus, in the Financial Report for 1973 the Statement of Income (Loss) reflected an excess project cost of $15,812,602 for the period March 31, 1973 through December 31, 1973, and a project loss of $27,380,062 which WTC incurred during the period beginning with WTC's inception until March 31, 1973. In 1974, WTC increased its excess project cost of $15,812,602 by $28,296,870 to $44,109,472, and the project loss figure of $27,380,062 was increased by $8,500,000 to $35,880,062 as a provision for anticipated loss. In 1975, the WTC members decided that there was no present expectation that work under the tunnel contracts would resume because of the disputes between WTC and the City and because of the financial difficulties the City was suffering at the time. For this reason and because of accounting requirements resulting from the City's declaration of default and possession of the Tunnel Project construction sites and assets, the WTC management committee decided to stop treating WTC's disputed claims, including those involving physical assets, as assets in the financial statement on December 30, 1975. Thus, in financial reports for 1975 WTC's accountants wrote off the $35,609,472 remaining excess project costs which had been carried as an asset from 1974. They wrote off $29,694,909 in project losses which included $27,380,062 in losses that WTC incurred from its inception through March 31, 1973 and $2,314,847 in losses which WTC incurred in 1975. Also, WTC wrote down the project assets to realizable value which resulted in a loss on WTC's financial report of $23,225,737. Thus, the financial report reflected a net loss of $61,150,056 for the year 1975, and a net loss of $97,030,118 for the period beginning with WTC's inception through December 31, 1975.

WTC elected to use the completed contract method of accounting for reporting income and expenses arising from the

construction of the water tunnel in its 1970 partnership return. WTC never received permission to change this method.

The 1973 WTC partnership return reflected an ordinary loss of $13,113,685. On their consolidated United States Corporation Income tax Return for 1973, petitioners deducted their 30 percent distributive share of this ordinary loss or $13,113,685. Petitioners thereafter agreed to respondents' disallowance of this deduction.

In its partnership return for 1974, WTC reported an ordinary loss of $28,362,292 and indicated that Walsh's 30 percent distributive share was $8,508,688. On their consolidated return for 1974, petitioners deducted $8,528,315 with respect to the Tunnel Project.

For 1975, WTC reported an ordinary loss of $69,331,882. WTC arrived at this figure by calculating the excess of direct project costs for the life of the enterprise, or $217,537,597, plus the project shutdown writeoffs, or $23,225,737, over the gross receipts from the entire project or $143,069,160. The total net loss for the project was thus $97,694,174, but this figure was reduced by the $28,362,292 loss reported on the 1974 return, to arrive at $69,331,882. The following chart illustrates this computation.

Income From Operations		From Inception to December 31, 1975
Gross receipts		$143,069,160
Cost of operations:		
Direct costs	$120,274,124	
Depreciation and plant amortization	27,269,688	
Overhead expense	69,993,785	217,537,597
		(74,468,437)
Project shutdown writeoffs:		
Accounts receivable	(887,226)	
Construction bond premium	(597,253)	
Plant and utilities	(11,957,536)	
Inventories	(2,401,735)	
Deferred construction costs	(7,381,987)	(23,225,737)
Net income (loss) from inception to December 31, 1975		(97,694,174)
Add back loss reported per tax return for calendar year 1974		28,362,292
Income (loss) from operations		$(69,331,882)

WTC reported Walsh's 30 percent distributive share of the loss reported for 1975 as $20,799,565. However, on their consolidated return for 1975, petitioners deducted $21,829,891 with respect to the Tunnel Project.

Respondent does not dispute the gross receipts figure for WTC. Nor does respondent dispute the $217,537,597 "costs of operations" figure. However respondent does contest the deduction of these losses in 1975 or any earlier year. In addition, in the event we find that either 1974 or 1975 is the year of completion of the Contract, respondent disputes certain items comprising the $23,225,737 project shutdown writeoff. These items include—

(1) $11,957,536 which is the unamortized value on WTC's books of construction plant and utilities.

(2) $2,401,735 representing inventories which the City possessed pursuant to the July 9, 1975 default declaration.

(3) $2,950,552 which is the amount by which the cost to WTC of clad steel pipe and other materials purchased for installation in the tunnel exceeds the amounts which the City paid to WTC for these items.

(4) $758,735, a net amount representing the excess of $3,758,735 previously accrued but unpaid contract receivables ($3,197,874 of which represents contract retainages primarily in the form of tax-exempt bonds), over the $3 million unamortized balance of amounts that the City had advanced to WTC.

OPINION

The first issue for decision arising out of the foregoing facts is whether it was proper for WTC to report its losses from the Tunnel Project in 1975 or an earlier year, and thus whether petitioner properly reported their distributive share of the loss in such years.

WTC elected the completed contract method of reporting income and expenses. Pursuant to authority granted by Congress, sections 451 and 7805, I.R.C. 1954, the Secretary has promulgated regulations detailing the use of this accounting method. Sec. 1.451-3(d)(1), Income Tax Regs., provides:

> [U]nder the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross

> income for the taxable year in which such contract is completed (as defined in paragraph (b) (2) of this section). All costs which are properly allocable to a long-term contract (determined pursuant to subparagraph (5) of this paragraph) must be deducted from gross income for the taxable year in which the contract is completed. In addition, account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion.

The regulations further provide that "a long-term contract will not be considered 'completed' until final completion and accepance have occurred." Sec. 1.451-3(b)(2), Income Tax Regs. The regulations thus delay the deduction of expenses and the accrual of income arising from a long-term contract, where the taxpayer employs the completed contract method, until the year in which the contract is completed, and the subject matter of the contract, in this case the water tunnel, is tendered to the owner or buyer. This accounting method may be a boon to the taxpayer whose long-term contracts prove profitable because it effectively delays accrual of income which the taxpayer would have reported in earlier years using other accounting methods. Unfortunately for a taxpayer whose long-term contract results in losses, as did WTC's, the completed contract method may prove to be a disadvantage because it delays the reporting of losses. In this case, petitioners' joint venture entered a terribly costly project losing approximately $75 million, considering the 1979 settlement, and its desire to deduct those losses in 1975, rather than later, is certainly understandable.

The first point of contention between petitioners and respondent is whether the contract was in fact completed in 1975 or earlier; the petitioners contend that it was, while respondent contends that it was not. Most of the case law interpreting the meaning of "completed" is not entirely apposite. These cases involve the question of whether the year for reporting income is the year in which the contractor literally completes the project or in a prior year when the contractor "substantially" completes the project. In *E.E. Black, Ltd. v. Alsup,* 211 F.2d 879 (9th Cir. 1954), the Court of Appeals for the Ninth Circuit interpreted the

words literally and concluded that a taxpayer using the completed contract method of accounting could report income in 1945, when it installed the thermostats for the fire alarm system in the building it constructed and received the final payment of $533.50, rather than 1944 by which year the taxpayer substantially completed the building and received $44,000 of the contract price. *E.E. Black, Ltd. v. Alsup, supra* at 880. See also *Thompson-King-Tate, Inc. v. United States,* 296 F.2d 290 (6th Cir. 1961). This Court has held that income and expenses should be reported in the year of substantial completion even though the contract is not entirely completed and accepted until a later year, because the taxpayer was entitled to payment upon substantial completion of the contract and therefore had completed the contract for the purposes of the regulations. *Ehret-Day Co. v. Commissioner,* 2 T.C. 25, 32-35 (1943). In cases where this Court has held that contracts were substantially completed and thus completed for the purposes of the regulations, at least 98 percent of the contract work had been performed.[1]

WTC in this case completed less than 60 percent of the contract work in 1975. However, it "terminated" performance in that year, and by the end of 1975 it appeared that WTC would not resume work under the contract. WTC encountered unforeseen circumstances in constructing the tunnel which resulted in costs which grossly exceeded payments as set forth in the contract. WTC attempted to renegotiate the contract with the City, but by the end of 1975 negotiations had failed and both WTC and the City realized that WTC would not resume. Indeed, WTC had abandoned the worksites and either laid off or transferred employees who were connected with tunnel construction. The City possessed the site and the equipment and supplies and by 1976 it began to contract portions of the tunnel construction to other parties. The issue is, therefore, whether the cessation of work coupled with the claims each party made against the other was tantamount to final completion and acceptance.

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[1] See, e.g., *Wohlfeld v. Commissioner,* T.C. Memo. 1958-128 (loss from contract reportable in year was 98.26 percent completed).

Petitioners rely upon the dispute provisions of the regulations to argue that in this case final completion is unnecessary because the dispute provisions govern in cases where a party ceases work under a contract after completing only a portion of the work. These provisions, section 1.451-3(d)(2), (3), and (4), Income Tax Regs., however, are inapplicable to the case because they involve cases where a contract, although not entirely completed, is substantially completed, and there are disputes between buyer and seller. At first blush it might appear that section 1.451-3(d)(3), Income Tax Regs., headed "Contracts with disputes from taxpayer claims," is applicable because the City had not yet brought its counterclaim in 1975. Further, section 1.451-3(d)(4), Income Tax Regs., headed "Contracts with disputes from both buyer and taxpayer claims" might seem to apply because by 1977 the City entered its counterclaim against WTC. These regulations do not specifically say that the contract must be substantially completed. However, the examples which demonstrate the operation of the regulations make it obvious that these regulations do not apply in cases where midstream termination of performance occurs. Sec. 1.451-3(d)(3)(v), example 1, Income Tax Regs., provides—

> S, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a building for T pursuant to a long-term contract. Under the terms of the contract, S is entitled to receive $100,000 upon completion of the building. S finishes construction of the building in 1974 at a cost of $105,000. T examines the building in 1974 and agrees that it meets his specifications; however, as of the end of 1974, S and T are unable to agree as to the merits of S's claim for an additional $10,000 for certain items which S alleges are changes in contract specifications and T alleges are within the scope of the contract's original specifications. Under these circumstances, S must include in income in 1974 the gross contract price of $100,000 and must deduct from gross income in such year the $105,000 of costs. In 1975 the dispute is resolved by a payment to S of $2,000 with respect to his claim. S must include this $2,000 in gross income in 1975.

The example clearly points out that "S *finishes* construction of the building." The example indicates that the dispute provision does not apply until the building is completed. The examples illustrating section 1.451-3(d)(4), Income Tax Regs., both also consider situations in which the subject matters of the contract are completed. See sec. 1.451-3(d)(4)(ii), examples (1) and (2), Income Tax Regs. See also the examples under sec. 1.451-3(d)(2)(vii), Income Tax Regs.

In addition, the dispute provisions provide a method for calculating the income and expense to be reported in the year of contract completion. Regardless of which party to the contract is pressing claims, the starting figure is the "gross contract price." Sec. 1.451-3(d)(3)(ii), Income Tax Regs. If the contract involves disputes from taxpayer claims, that is if the taxpayer claims an amount in addition to the gross contract price, sec. 1.451-3(d)(3)(i), Income Tax Regs., then, in the year of completion, the taxpayer must include the entire amount of the gross contract price, without regard to the dispute, and deduct all costs which are properly allocable to the contract. Sec. 1.451-3(d)(3)(ii), Income Tax Regs. Any further income is included when the taxpayer's claim is resolved. Sec. 1.451-3(d)(3)(iii), Income Tax Regs. In the event of disputes from both buyer and taxpayer claims, the taxpayer must include in income the gross contract price reduced by the amount reasonably in dispute with respect to the buyer's claim, and must report expenses reduced by the amount by which the gross contract price was reduced. Sec. 1.451-3(d)(4)(ii), examples (1) and (2). The gross contract price means "the original stated price of the contract with any modifications to which the parties have agreed as of the end of the taxable year." Sec. 1.451-3(d)(3)(iv), Income Tax Regs. In the instant case, the agreed upon figure for 1975 was approximately $220 million.

While it is true that the City had accepted only the portion of the work which WTC completed, and approved payment for this portion of the work, the gross contract price means the total price payable for the entire contract. Petitioners argue that the gross contract price means only the approximately $140 million paid and payable for the work completed because the total price was a

summation of unit prices and prices for lump-sum items and the City would pay for each unit or lump-sum item as it was constructed. However, this argument is inconsistent with the nature of a completed contract accounting method which provides for the reporting of all contract receipts in one accounting period. If, as petitioners suggest, the contract is severable into the components in this case, then petitioners should report the income and expense from each unit of the contract in the year of completion of such unit. This obviously is not how the completed contract method of accounting works.

Furthermore, if we applied the dispute provisions and used the entire price for work completed and to be completed under the contract, or approximately $220 million, as the gross contract price, we would reach an absurd result because in 1975 WTC had completed less than 60 percent of the work called for under the contract and was entitled to no more than this portion of the gross contract price. It would make no sense for the petitioners or WTC to report as income that portion of the contract price which had not yet accrued.

In holding that the dispute provisions do not apply to this case, we are left with the regulation containing the general rule and the case law. As noted above, the regulation requires "final completion and acceptance" of the contract before income and expenses are to be reported. Sec. 1.451-3(b)(2) and (d)(1), Income Tax Regs. A contract is "an agreement *** to do *** a particular thing." Black's Law Dictionary, revised 4th ed. (1968) p. 394. The thing agreed upon herein was the construction of a water tunnel from the Bronx to Queens including shafts, valve chambers, etc. The parties treated all of the agreements in respect of this tunnel as one contract. For accounting purposes, WTC treated these agreements as one contract through 1973, and for tax purposes, it and petitioners treated the tunnel contract as one contract. See, e.g., *National Contracting Co. v. Commissioner,* 25 B.T.A. 407, 411 (1932), affd. 69 F.2d 252 (8th Cir. 1934). Whatever may have happened in 1975, final completion of the thing agreed upon, that is completion of the water tunnel, as the regulations require, had not occurred. Concededly, WTC and the City could have truncated the contract such that the work

completed by 1975 would have been all or substantially all of the work required under the contract, because a modification mutually agreed upon would have been the contract for tax purposes. See sec. 1.451-3(d)(3)(iv), Income Tax Regs.[2] However, WTC's unilateral decision to terminate performance followed by the City's possession of the tunnel and associated assets does not constitute a mutually agreed upon modification of the contract. The City's counterclaim in 1977 for breach of contract underscores this conclusion.

While our exhaustive research has revealed no case directly on point, there are cases that are instructive.[3] In one case the Board of Tax Appeals decided that several agreements for the construction of two school buildings constituted one contract, and "that completion thereof required the discharge of the obligations undertaken in each of such contracts." *National Contracting Corp. v. Commissioner, supra* at 411.

In *Fort Pitt Bridge Works v. Commissioner,* 92 F.2d 825 (3d Cir. 1937), revg. 24 B.T.A. 626 (1931), the issue in part was whether a contract was terminated in 1918 followed by another contract, or whether there was only one contract. The contractor in this case had a contract with the Army to build hangars. The Army sent notice before the performance was completed that it was canceling all orders with respect to the hangars. The contractor then notified the Army that it was complying with these instructions. Thereafter, the Army informed the contractor

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[2] See e.g., *A.S. Wikstrom, Inc. v. Commissioner,* T.C. Memo. 1969-32.

[3] *National Contracting Co. v. Commissioner,* 37 B.T.A. 689, 701 (1938), affd. 105 F.2d 488 (8th Cir. 1939), is inapposite because as the Board noted:

> [T]he petitioner's claim is not disputed that contract 53 was completed so far as the petitioner was concerned in 1919 and was so treated. It is not, therefore, necessary for us to consider whether the petitioner might, under the completed contract method of accounting and in accordance with a consistent practice, have treated [the] contract as open until all claims arising out of it were settled.

of its decision not to cancel the contract and in fact ordered the contractor to ship a portion of the hangars originally ordered. The Court of Appeals for the Third Circuit held that on these facts, the Government had canceled the contract and that the petitioner or contractor impliedly agreed to such cancellation. Therefore, the contract was terminated, and for tax purposes was completed. *Fort Pitt Bridge Works v. Commissioner, supra* at 828-829. Thus, it appears that one party to a contract may not unilaterally withdraw from a contract even for bona fide financial reasons, and consider the contract complete for tax purposes. In other words, WTC may not accelerate the deduction of costs incurred in fulfilling the obligations under the contract by terminating performance and suing for a quantum meruit recovery. The other party must consent to such withdrawal in order to truncate the contract such that it may be considered completed and the taxpayer's obligation performed. Here, there is no indication that the City consented to WTC's cessation of performance in 1975. It appears that the City, far from consenting to WTC's cessation of work, took all steps that it could to have WTC comply with the Contract obligations by declaring it in default, enforcing its security agreements, and counterclaiming for breach of contract. Thus, at the end of 1975, WTC still had unfulfilled obligations under the Contract which had not been fulfilled by performance, or avoided by agreement or injunction.

In sum, petitioner would have us hold that a long-term contract is completed when the contractor has terminated its performance (whenever that might be) under the contract. We do not believe that the law permits one party to determine unilaterally when a contract has been fulfilled. While we do not say that the last nail must be driven, we do say, as the regulations imply, that the contract must be substantially physically completed before the long-term method of accounting becomes operative. We do not need to define "substantially" precisely since here petitioners had completed less than 60 percent of the contract, far short of any reasonable definition of the term "substantial completion."

An additional reason prevents us from concluding that WTC could report its income and expenses from the Contract in 1975 or earlier. That is, since we have decided that the dispute provisions

do not apply to this case, specifically section 1.451-3(d)(3), Income Tax Regs., the case law requires that where a long-term contract winds up with claims such as those involved in this case, an entity must defer reporting income and expenses until such time as it can determine whether the contract will result in a net gain or a net loss. In *C.H. Leavell & Co. v. Commissioner,* 53 T.C. 426, 438 (1969), the Court noted that "the outcome of a pending dispute may involve such a substantial amount as to make ascertainment of the contract results in terms of gain or loss impossible, and thereby justify a delay in reporting any of the contract income."[4] See also *Smith v. Commissioner,* 66 T.C. 213, 219 (1976); *Carolina Contracting Co. v. Commissioner,* 32 B.T.A. 1171, 1176 (1935).

In this case, in 1975, WTC was suing the City for an amount in excess of the net loss WTC claimed it suffered from the Tunnel Project. WTC also sought compensation for or recovery of the items the City had possessed upon declaring WTC in default. Moreover, the City had not yet asserted its counterclaims in 1975. Thus, in 1975, it was not possible to tell whether WTC ultimately would suffer a loss or enjoy a gain.

We recognize that our decision that 1975 is not the year of contract completion precludes the deduction of the project shutdown writeoffs in any of the years at issue. However, additional reasons compel us to deny the deduction of this particular item. With respect to the project shutdown writeoffs, petitioners contend that the value of some of these properties including the clad steel pipe and structural steel, inventories and the construction plant and utilities was minimal because these items had been manufactured according to unique specifications and upon resale would have value only as scrap. Initially we note that petitioners did not present any evidence as to the value these

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[4] *B & H Construction & Supply Co. v. Commissioner,* T.C. Memo. 1978-195. In this case, petitioner had outstanding claims for work done under contract such that it could not be known during the year at issue whether petitioner would ultimately have a gain or loss on the contract. Therefore, the Court could not find that petitioner had sustained a deductible loss.

assets might have had to a contractor replacing WTC on the Tunnel Project.

In addition, the evidence indicates that WTC had not installed these materials, such as clad steel pipe and structural steel, in the tunnel by the end of 1975. Even assuming 1975 to be the year of completion, the regulations require that "account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion." Sec. 1.451-3(d)(1), Income Tax Regs. This means that in order to deduct the cost of these materials in 1975, they must have "become an integral part of the subject matter of the long-term contract and those materials which are consumed in the ordinary course of building [or] constructing *** the subject matter of a long-term contract." Sec. 1.451-3(d)(5)(i), Income Tax Regs.[5] Since the materials in question were neither consumed nor installed, their cost would not be deductible even assuming 1975 as the year of completion.

In respect of $758,735 excess of previously accrued contract receivables over the unamortized amount of City advances to WTC, the amounts comprising the receivables consisted of several items. One item was "due for current estimate" in the amount of $95,002. This item had been submitted to the City on an estimate, but the City disputed this item and did not pay it. Assuming 1975 was the year of completion, this item would not be included in income because disputed items such as this are not included until the dispute is resolved, *Smith v. Commissioner*, 66 T.C. 213, 218-219 (1976). See, e.g., sec. 1.451-3(d)(2)(iii), Income Tax Regs. The $513,858 item "due for unbilled work" related to work which was performed but for which WTC had not yet submitted an estimate to the City. This appears to be further evidence that the contract was not completed as of 1975.

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[5] While the regulation was promulgated in 1976, T. D. 7397, 1976-1 C.B. 115, we note that the Secretary's regulations are to be retroactive unless otherwise indicated, sec. 7805(b). See, e.g., *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 135 (1936), affg. 76 F.2d 892 (2d Cir. 1935), and 29 B.T.A. 395 (1933); *Pollack v. Commissioner*, 392 F.2d 409 (5th Cir. 1968), affg. 47 T.C. 92 (1966).

Obviously this portion of the contract work had not yet been accepted as required by both the regulations, sec. 1.451-3(b)(2), Income Tax Regs., and the case law. *Martin v. Commissioner,* 34 B.T.A. 111, 116 (1936). While this is an insignificant amount of work compared to the entire contract and might not prevent completion under this Court's substantial completion test rather than the Ninth Circuit's test, under the circumstances where over 40 percent of the contract was uncompleted in 1975, this item is merely another indication that the contract was still incomplete. Nevertheless, if 1975 were the year of completion, it appears that the item should be included in WTC's income because there was no dispute with respect to it. The final items were retainages. There is no indication that in 1975 these amounts were in dispute, and the mere fact that the City withheld payment of these retainages does not prevent their inclusion and does not justify their deduction even assuming 1975 was the year of completion. See, e.g., *Orino v. Commissioner,* 34 B.T.A. 726, 730-731 (1936).

In respect of the items comprising the writeoff and which the City possessed pursuant to the default declaration, the fact remains that as of the end of 1975, WTC was suing to recover the items. Even assuming 1975 to be the year of completion, WTC may not take a deduction for these items. As noted above, WTC had not used or completely depreciated these items in the course of completing the tunnel, and therefore could not take deductions for these items as expenses or losses attributable to the Contract. Otherwise, as respondent suggests, WTC must rely upon section 165[6] to justify the deduction. Section 1.165-1(d)(2)(i), Income Tax Regs., provides—

> If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be

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[6] Section 165(a) provides:
There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

> ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

On the facts of this case, WTC was suing the City to obtain a recision of the default declaration and to recover the assets seized pursuant to the declaration and to obtain compensation for the assets. As of 1975, it appeared that WTC might expect a recovery with respect to these assets; certainly WTC expended great sums in pursuing its litigation, and it does not appear that this litigation was "specious, speculative, or wholly without merit." See *Scofield's Estate v. Commissioner*, 266 F.2d 154, 159 (6th Cir. 1959), revg. in part 25 T.C. 774 (1956). See also *Kugel v. Ryan*, 289 F.2d 329, 330 (2d Cir. 1961).[7] Thus, since it appears that as of the end of 1975, there was a reasonable likelihood that WTC would recover the amounts in respect of these items[8] comprising the project writeoff, 1975 would not be the proper year for deducting those amounts as losses even assuming it was the year of contract completion. Accordingly, we hold that neither 1975 nor any earlier year was a proper year for deduction of the Tunnel Project losses.

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[7] See *Singleton v. Commissioner*, T. C. Memo. 1977-98, affd. 606 F.2d 50 (3d Cir. 1979).

[8] It would appear that section 166 would apply to the contract receivables. However, since there was a reasonable prospect of recovery with respect to these items in 1975 a deduction for the receivables in 1975 would be improper.

II. Western Hemisphere Trade Corporation Deduction

FINDINGS OF FACT

Atkinson-International Dominican Republic (hereinafter AIDR), formerly known as Walsh-WHTC, Inc., was a member of petitioners' consolidated return group for 1975. AIDR's primary business during 1975 was the construction of the Sabana Yegua Dam (hereinafter the Dam) and related activity for the Government of the Dominican Republic, near the City of San Juan de la Maguana in the Dominican Republic. The basic components of the Dam were the earth dam, a surface spillway, the bottom outlet of two tunnels, a tunnel intake, and a hydroelectric plant. In constructing the Dam, AIDR had to perform various tasks including land clearing; river diversion and water control; open cut excavation; embankment fill; grouting (concrete filling) and related drillings; pouring concrete for foundation; installation of reinforcing steel and miscellaneous features; masonry; laboratory testing; underground excavation and installation of tunnel access shafts and tunnel gates; construction of ancillary buildings; compaction of fill; preparation of access roads; installation of fences and gates; and transportation, erection and testing of an electrical powerhouse, hydric-sanitary facility, and mechanical and electrical equipment. In addition, the contract for the construction of the Dam required AIDR to supply all the materials required for the satisfactory completion of the Dam, including satisfactory fill material, concrete, cement, reinforcing steel, and iron. In addition, AIDR provided such items as sliding and wheel gates, a butterfly valve, turbines, generators, and transformers.

AIDR reported its income from its construction activity using the percentage of completion method of accounting. In their consolidated return for 1975, petitioners reported AIDR's income as follows:

Gross receipts	$16,228,166.00
Cost of operations	15,410,271.16
Gross profit	817,894.84
Other interest	517,543.00
Other income	3,231.00
Total income	1,338,668.84
Other deductions	5,974.00
Taxable income	1,332,694.84

OPINION

The issue for decision is whether AIDC qualified as a Western Hemisphere Trade Corporation (WHTC) for the year 1975. The law as in effect for that year[9] allowed a deduction for a WHTC in calculating its taxable income in accordance with a formula set forth in section 922 if a corporation qualified under tests set forth in section 921. Section 921 provides—

> For purposes of this subtitle, the term "Western Hemisphere trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:
>
> (1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and
>
> (2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

In the case of AIDR, there is no dispute with respect to how much gross income it earned from sources within the United States or from something other than the active conduct of a trade or business. Nor is there any dispute that the gross income earned from the construction of the Dam would be qualifying gross income for the purposes of section 921. However, in order for AIDR to satisfy the section 921 tests, that is for its gross income from the Dam to at least equal 95 percent and 90 percent of its entire gross income for the purposes of section 921(1) and (2), respectively, the gross income must be equivalent to the gross receipts from the Dam. If AIDR's gross receipts are reduced by cost of goods sold or of operations, in arriving at gross income, as respondent contends, AIDR would fail both the section 921(1)

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[9] The allowance of a deduction for WHTCs was repealed by sec. 1052, Tax Reform Act of 1976, 90 Stat. 1647, Pub.L. 94-455.

and (2) tests and lose the section 922 deduction. Simply stated, the issue for our decision is whether AIDR's gross income from constructing a dam equals its gross receipts, or gross receipts less cost of operations, for the purposes of section 921(1) and (2).

Neither section 921 nor the regulations thereunder provide a definition of gross income. However, AIDR reported its income from the Dam using the percentage of completion method, and the regulations pertaining to this method are most helpful.

> Under the percentage of completion method, the portion of the *gross contract price* which corresponds to the percentage of the entire contract which has been completed during the taxable year must be included in *gross income* for such taxable year. Section 1.451-3(c)(1), Income Tax Regs. (Emphasis added).
>
> Further—
>
> Under the percentage of completion method, all costs incurred during the taxable year with respect to a long-term contract (account being taken of the material and supplies on hand at the beginning and the end of the taxable year for use in the contract) must be *deducted.* Section 1.451-3(c)(3), Income Tax Regs. (Emphasis added.)

The regulations clearly indicate that the portion of the gross contract price, which AIDR reported as gross receipts, is gross income, and that the costs are to be deducted. It is clear that while cost of goods sold is offset against gross receipts in the computation of gross income, deductions are subtracted from gross income in arriving at taxable income. *Curtis Gallery & Library, Inc. v. United States,* 388 F.2d 358, 361 (9th Cir. 1967); *B.C. Cook & Sons, Inc. v. Commissioner,* 65 T.C. 422, 428-429 (1975), affd. 584 F.2d 53 (5th Cir. 1978). Thus, it would seem that AIDR's gross receipts, computed under the percentage of completion method, must be equivalent to gross income from which the costs are deducted in arriving at taxable income.

We are cognizant of the regulations under section 61 which provide—

> In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Section 1.61-3(a), Income Tax Regs.

Is the construction of a dam equivalent to manufacturing, merchandising, or mining, or to something else, such as services?

We note that whether an item is subtracted from gross receipts to arrive at gross income, or is deducted from gross income to arrive at taxable income, usually makes no difference because the figure upon which tax is imposed, taxable income, will remain the same in either case. See, e.g., R. Magill, Taxable Income, 363 (1945). However, in some instances, as in this case, the amount of gross income is as important because certain sections of the Code rely upon gross income as a ceiling or as an aid in definition.

An example of this is section 151 which allows as a deduction an exemption for a dependent whose gross income for the year is less than $1,000. Sec. 151(e)(1)(A). In *Hahn v. Commissioner,* 30 T.C. 195 (1958), affd. 271 F.2d 739 (5th Cir. 1959), this Court considered section 25(b)(1)(D) of the 1939 Code which provided for an exemption for each dependent whose gross income was less than $600. *Hahn v. Commissioner, supra* at 197. In that case, the taxpayer claimed an exemption for his father who operated a blacksmith and welding shop. The issue was whether the father's gross income was equivalent to the gross receipts of the business, or was the gross receipts less cost of goods sold. Although the father made some parts for farm machinery, he "was primarily engaged in repairing plows, trailers, combines, and other types of farm equipment." *Hahn v. Commissioner, supra* at 196-197. This Court held that gross income equalled gross receipts because "what [the father] was selling, for the most part at least, was not a material product to which direct costs could be allocated as in the case of a manufacturing business, but rather * * * services, consisting of his ability, know-how, and experience as a blacksmith and welder in the repair and maintenance of farm machinery and equipment." *Hahn v. Commissioner, supra* at 198. Thus, where a business is engaged primarily in the providing of service, rather than mining,

manufacturing or merchandising, the business gross receipts will constitute gross income.[10]

In this case, while AIDR did in fact construct a dam and related structures, their function was primarily performing a service rather than mining, manufacturing or merchandising. AIDR did not build many dams at one location and ship one to the site in the Dominican Republic. Nor did it construct the dam from a standard set of plans. See, e.g., *Pope v. Commissioner,* T.C. Memo. 1965-211. Rather, this was an onsite construction of a unique item specifically designed and constructed in accordance with geological and environmental considerations particular to that site and to serve the particular purposes demanded by the buyer.

We hold that, for the foregoing reasons, AIDR was furnishing services. Accordingly, we hold that AIDR is entitled to a WHTC deduction for the year 1975.

Decision will be entered under Rule 155.

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[10] Other cases wherein this Court has required the subtraction of costs of goods sold from gross receipts involved the production of milk, cream and butter by a dairy farm. *Garrett Holding Corporation v. Commissioner,* 9 T.C. 1029, 1034-1035 (1947); *Woodside Acres, Inc. v. Commissioner,* 46 B.T.A. 1124 (1942), affd. 134 F.2d 793 (2d Cir. 1943).

Appendix D

Income Tax Regulations section 1.451-3 promulgated in final form T.D. 7397, 41 F.R. 2637, Jan. 19, 1976 (26 C.F.R. § 1.451-3 (4-1-85)), provides:*

§ 1.451-3 Long-term contracts.

(a) In general. (1) Income from a long-term contract (as defined in paragraph (b)(1) of this section) may be included in gross income in accordance with one of the two long-term contract methods, namely, the percentage of completion method (as described in paragraph (c) of this Section) or the completed contract method (as described in paragraph (d) of this section), or any other method if the method chosen clearly reflects income. Whichever method is chosen, it must be applied consistently to all long-term contracts within the same trade or business except that a taxpayer who has long-term contracts (as defined in paragraph (b)(1) of this section) of substantial duration and long-term contracts of less than substantial duration in the same trade or business may report the income from all the contracts of substantial duration on the same long-term contract method and report the income from the contracts of less than substantial duration pursuant to another proper method of accounting. For example, if a manufacturer of heavy machinery has special-order contracts of a type that generally take 15 months to complete and also has contracts of a type that generally take 3 months to complete, the manufacturer may use a long-term contract method for the 15-month contracts and a proper inventory method pursuant to section 471 and the regulations thereunder for the 3-month contracts. Similarly, if a construction contractor has construction contracts of a type that generally take 15 calendar months to complete and other constructions contracts that take only 5 months to complete but that are long-term contracts because they are not completed in the taxable years in which they

* Section 1.451-3 was amended in 1986. The amendment was expressly made applicable only to taxable years ending after December 31, 1982 (Income Tax Regs., § 1.451-3(a)(7)). The regulations reproduced here govern the years at issue in this case (ibid.).

are entered into (pursuant to paragraph (b)(1)(i) of this section), such contractor may either use a long-term contract method for all the contracts of both types or use a long-term contract method for the 15-month contracts and another proper method of accounting for the 5-month contracts. If a taxpayer distinguishes between contracts of substantial duration and other long-term contracts of less than substantial duration, he must adhere to a consistently applied standard for determining substantial duration.

(2) When a taxpayer reports income under the percentage of completion method or the completed contract method, a statement to that effect shall be attached to his income tax return.

(3) The percentage of completion method and the completed contract method apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, such as investment income or expenses not attributable to such contracts and costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and § 1.446-1(c).

(b) Definitions. (1) (i) Except as provided in subdivision (ii) of this subparagraph, the term "long-term contract" means a building, installation, construction or manufacturing contract which is not completed within the taxable year in which it is entered into.

(ii) Notwithstanding subdivision (i) of this subparagraph, a manufacturing contract is a "long-term contract" within the meaning of this subparagraph only if such contract involves the manufacture of (*a*) unique items of a type which is not normally carried in the finished goods inventory of the taxpayer, or (*b*) items which normally require more than 12 calendar months to complete (regardless of the duration of the actual contract). Thus, for example, a contract to manufacture a unit of industrial machinery specifically designed for the needs of a customer and not normally carried in the taxpayer's inventory or a contract to manufacture machinery which will require more than 12 calendar

months to complete are long-term contracts within the meaning of this subparagraph; however, a contract to manufacture 15,000 folding chairs which take 3 days each to manufacture is not a long-term contract within the meaning of this subparagraph even though it takes more than 12 calendar months to manufacture all 15,000 chairs and the contract is not completed within the taxable year it is entered into.

(2) For purposes of this section, except as otherwise provided in this subparagraph and paragraph (d) (2), (3), and (4) of this section (relating to certain disputes), a long-term contract will not be considered "completed" until final completion and acceptance have occurred. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring Federal income tax. With respect to a subcontractor who completes his work on a long-term contract prior to the completion of the entire contract, "final completion and acceptance" of the contract with respect to such subcontractor shall be deemed to have occurred when his work has been completed and has been accepted by the party with whom he has contracted.

(c) Percentage of completion method. (1) Under the percentage of completion method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year must be included in gross income for such taxable year.

(2) The determination of the percentage of completion of a contract generally may be made on either of the following methods:

(i) By comparing, as of the end of the taxable year, the costs incurred with respect to the contract with the estimated total contract costs, or

(ii) By comparing, as of the end of the taxable year, the work performed on the contract with the estimated total work to be performed.

In determining the percentage of completion pursuant to subdivision (i) of this subparagraph with respect to a long-term

contract, a taxpayer may use any method of cost comparisons (such as comparisons of total direct and indirect costs incurred to date to estimated total direct and indirect costs, of total direct costs incurred to date to estimated total direct costs, or of direct labor costs incurred to date to estimated total direct labor costs) so long as such method is used consistently with respect to such contract and such method clearly reflects income. In determining the percentage of completion pursuant to subdivision (ii) of this subparagraph, the criteria used to compare the work performed on a contract as of the end of the taxable year with the estimated total work to be performed must clearly reflect the earning of income with respect to the contract. Thus, for example, in the case of a roadbuilder, a standard of completion based solely upon miles of roadway completed in a case where the terrain is substantially different with respect to roadway completed during one taxable year as compared with roadway completed during another taxable year may not clearly reflect the earning of income with respect to the contract. If the method described in subdivision (i) of this subparagraph is used and the taxpayer revises the estimated total costs as of the end of a taxable year, certificates of architects or engineers or other appropriate documentation showing the basis for such revision must be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return. If the method described in subdivision (ii) of this subparagraph is used, certificates of architects or engineers or other approriate documentation showing the percentage of completion of each contract during the taxable year must be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(3) Under the percentage of completion method, all costs incurred during the taxable year with respect to a long-term contract (account being taken of the material and supplies on hand at the beginning and the end of the taxable year for use in the contract) must be deducted. "Costs incurred during the taxable year with respect to a long-term contract" do not include costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject

matter of the long-term contract. See paragraph (a)(3) of this section.

(d) Completed contract method—(1) In general. Except in cases to which subparagraph (2), (3), or (4) of this paragraph applies, under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which such contract is completed (as defined in paragraph (b)(2) of this section). All costs which are properly allocable to a long-term contract (determined pursuant to subparagraph (5) of this paragraph) must be deducted from gross income for the taxable year in which the contract is completed. In addition, account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion.

(2) Contracts with disputes from buyer claims. (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract to the party with whom he is contracting, there exists an amount reasonably in dispute because such party wishes to have the original contract price reduced or to have additional work performed on the contract. Any item of income or deduction with respect to an amount reasonably in dispute shall be taken into account in the taxable year in which such dispute is resolved. In addition, any item of income or deduction which is properly allocable to such contract and which is not included in or deducted from gross income in a prior taxable year pursuant to subdivisions (ii), (iii), (iv), or (v) of this subparagraph and which is not taken into account under the preceding sentence shall be included in or deducted from gross income in the taxable year in which the final dispute is resolved.

(ii) If the amount reasonably in dispute affects so much of the contract price that it is not possible to determine whether a profit (an excess of the gross contract price over the costs properly allocable to such contract) or loss (an excess of the costs properly allocable to the long-term contract over the gross contract price) will ultimately be realized on such contract, then no item of income or deduction which is properly allocable to such contract

shall be included in or deducted from gross income in the taxable year in which such contract is completed without regard to such dispute).

(iii) In all other cases, the entire amount of the gross contract price reduced (but not below zero) by an amount equal to the amount reasonably in dispute shall be included in gross income in the taxable year in which such contract is completed (without regard to the dispute).

(iv) If the taxpayer is assured of a profit on such contract regardless of the outcome of the dispute, then all costs which are properly allocable to such contract and which have been incurred prior to the end of the taxable year in which such contract is completed (without regard to the dispute) shall be deducted in such year.

(v) If the taxpayer is assured of a loss on such contract regardless of the outcome of the dispute, then there shall be deducted in the taxable year in which such contract is completed (without regard to the dispute) the total amount of costs properly allocable to such contract which are incurred prior to the end of such year reduced by the amount by which the gross contract price was reduced pursuant to subdivision (iii) of this subparagraph. All other costs which are properly allocable to such contract shall be deducted in the taxable year in which incurred.

(vi) For purposes of this paragraph, where there is additional work to be performed with respect to a contract in dispute, the term "taxable year in which the dispute is resolved" means the taxable year in which such work is completed rather than the taxable year in which the outcome of the dispute is determined by agreement, decision, or otherwise.

(vii) The application of this subparagraph may be illustrated by the following examples:

Example (1). X, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a building for Y pursuant to a long-term contract. According to the terms of the contract, the gross contract price is $2,000,000. X finishes construction of the building in 1972 at a cost of $1,900,000.

Y examines the building and is dissatisfied with the construction. He demands either alterations or a reduction in the gross contract. The amount reasonably in dispute is $500,000. This dispute affects so much of the contract price that X is unable to determine whether a profit or a loss will ultimately be realized on such contract. Accordingly, pursuant to this subparagraph, X does not include any portion of the gross contract price in gross income and does not deduct any costs which are properly allocable to the contract until the taxable year in which the dispute is resolved.

Example (2). A, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a bridge for B pursuant to a long-term contract. The terms of the contract provide for a $10,000,000 gross contract price. A finishes construction of the bridge in 1972 at a cost of $9,500,000. When B examines the bridge, he insists that either certain girders be repainted or that the contract price be reduced. The amount reasonably in dispute is $100,000. Since under the terms of the contract, A would be assured of a profit of at least $400,000 ($10,000,000−[$9,500,000 + $100,000]) even if the dispute were resolved unfavorable to A, $9,900,000 ($10,000,000−$100,000 in dispute) of the gross contract price must be included in A's gross income in 1972 and $9,500,000 of costs must be deducted from A's gross income in 1972 pursuant to this subparagraph. In 1973 A and B resolve the dispute, A repaints certain girders at a cost to A of $60,000, and A and B agree that the contract price is not to be reduced. In 1973 A must include $100,000 ($10,000,000−$9,000,000 [sic]) in gross income and must deduct $60,000 from gross income.

Example (3). M, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a plant for N pursuant to a long-term contract. Under the terms of the contract M is entitled to receive $1,000,000 upon completion of the plant. M finishes construction of the plant in 1973 at a cost of $1,200,000. N examines the plant and determines that an elevator operates unsatisfactorily and insists that M either replace the elevator or that the contract price be reduced. The amount reasonably in dispute is $100,000. Under the terms of the contract M would be assured of a loss of at least $200,000

($1,200,000–$1,000,000) even if the dispute were resolved in favor of M. Pursuant to this subparagraph M must include $900,000 ($1,000,000–$100,000) in gross income for 1973 and must deduct $1,100,000 ($1,200,000–$100,000) from gross income in 1973. In 1974 the dispute is resolved, and M replaces certain components of the elevator at a cost of $50,000. M must include $100,000 ($1,000,000–$900,000) in gross income for 1974, and must deduct $150,000 ($100,000 of previously undeducted costs plus $50,000 of additional costs) from gross income in 1974.

Example (4). Assume the same facts as in Example (3) except that N is insisting that the contract price be reduced because an elevator has insufficient capacity and that in 1974 the dispute is resolved by a reduction in the gross contract price of $40,000 (from $1,000,000 to $960,000). By the end of 1973, M is assured of a loss of at least $200,000 ($1,200,000–$1,000,000) under the terms of the contract even if the dispute were resolved in favor of M. Pursuant to this subparagraph, M must include in gross income for 1973 $900,000 ($1,000,000–$100,000) and must deduct from gross income in such year $1,100,000 ($1,200,000–$100,000). In 1974, when the dispute is resolved, M must include $60,000 ($960,000–$900,000) in gross income and must deduct $100,000 ($1,200,000–$1,100,000) from gross income.

Example (5). Assume the same facts as in Example (3) except that N is also insisting that the contract price be reduced by an additional amount because an underground storage facility has insufficient capacity. M determines that the total amount reasonably in dispute is $160,000, $100,000 attributable to the elevator plus $60,000 attributable to the underground storage facility. Under the terms of the contract, M would be assured of a loss of at least $200,000 ($1,200,000–$1,000,000) even if both disputes were resolved in favor of M. Pursuant to this subparagraph, M must include $840,000 ($1,000,000–$160,000) in gross income for 1973 and must deduct $1,040,000 ($1,200,000– $160,000) from gross income in 1973. In 1974 the dispute relating to the elevator is resolved, and M replaces certain components of the elevator at a cost of $50,000. M must include

$100,000 (the amount of the gross contract price not included in gross income in 1973 by reason of the elevator dispute) in gross income for 1974 and must deduct $150,000 ($100,000 of previously undeducted costs plus $50,000 of additional costs) from gross income in 1974. In 1975, the dispute relating to the underground storage facility is resolved by a reduction in the gross contract price of $20,000 (from $1,000,000 to $980,000). In 1975 M must include $40,000 ($60,000—$20,000) in gross income and must deduct $60,000 (his previously undeducted costs) from gross income.

(3) Contracts with disputes from taxpayer claims. (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract to the party with whom he is contracting, a dispute exists because the taxpayer is requesting that the amount to be paid to him under such contract be increased.

(ii) Except as provided in subparagraph (2) of this paragraph, in all cases described in subdivision (i) of this subparagraph, the entire amount of the gross contract price shall be included in gross income in the taxable year the contract is completed (without regard to the dispute), and all costs which are properly allocable to such contract and which have been incurred prior to the end of the taxable year in which such contract is completed (without regard to the dispute) shall be deducted in such year.

(iii) Any item of income which is properly allocable to such contract and which is not included in gross income in a prior taxable year pursuant to subdivision (ii) of this subparagraph shall be included in gross income in the taxable year in which any such dispute (or part thereof) is resolved. Any item of deduction which is properly allocable to such contract and which is incurred in a taxable year subsequent to the year such contract is completed (without regard to the dispute) shall be deducted from gross income in the taxable year in which such item of deduction is incurred.

(iv) For purposes of this paragraph, the term "gross contract price" means the original stated price of the contract with any modifications to which the parties have agreed as of the end of the

taxable year. Thus, for example, such term includes any amount which the taxpayer is claiming by virtue of changes in the specifications of the contract which the other parties to the contract have agreed is proper, but it does not include any amount which the contractor is claiming which is disputed by the other parties to the contract. However, no amount is excluded from the term, "gross contract price" solely because a party refuses to pay such amount when due. Thus, for example, if the parties to a contract agree that the gross contract price is $100,000, but a party refuses to pay $60,000 of such amount when due, such refusal does not prevent the gross contract price from being $100,000.

(v) The application of this subparagraph may be illustrated by the following examples:

Example (1). S, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a building for T pursuant to a long-term contract. Under the terms of the contract, S is entitled to receive $100,000 upon completion of the building. S finishes construction of the building in 1974 at a cost of $105,000. T examines the building in 1974 and agrees that it meets his specifications; however, as of the end of 1974, S and T are unable to agree as to the merits of S's claim for an additional $10,000 for certain items which S alleges are changes in contract specifications and T alleges are within the scope of the contract's original specifications. Under these circumstances, S must include in income in 1974 the gross contract price of $100,000 and must deduct from gross income in such year the $105,000 of costs. In 1975 the dispute is resolved by a payment to S of $2,000 with respect to his claim. S must include this $2,000 in gross income in 1975.

Example (2). Assume the same facts as in Example (1) except that S's claim for an additional $10,000 relates to two items which S alleges are changes in contract specifications, namely $7,000 for changes in the heating system and $3,000 for changes in the electrical system. In 1975 the dispute with respect to the electrical system is resolved by a payment to S of $750, and in 1976 the dispute with respect to the heating system is resolved by a payment to S of $1,250 and by S's performance of additional

work at a cost of $250. S must include the $750 in gross income for 1975 and the $1,250 in gross income for 1976, and S must deduct the $250 from gross income in 1976.

(4) Contracts with disputes from both buyer and taxpayer claims. (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract, a dispute exists involving both claims by the taxpayer for an increase in the contract price and claims by the other party to the contract either for a reduction in the contract price or for the performance of additional work under the contract. In any case described in the preceding sentence, principles similar to the principles of subparagraphs (2) and (3) of this paragraph shall be applied.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). W, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a factory for Z pursuant to a long-term contract. Under the terms of the contract, Z agrees to pay W a total of $100,000 for construction of the factory. W finishes construction of the factory in December 1974 at a cost of $110,000. When Z examines the factory in December 1974, Z is dissatisfied with the location and workmanship of certain heating ducts. As of the end of 1974, W contends that the heating ducts as constructed are in accordance with contract specifications. The amount reasonably in dispute with respect to the heating ducts is $6,000. As of this time, W is claiming $14,000 in addition to the original contract price for certain changes in contract specifications which W alleges have increased his costs. Z denies that such changes have increased W's costs. In 1975 the disputes between W and Z are resolved by performance of additional work by W at a cost of $1,000 and by an agreement that the contract price would be revised downward to $96,000. Under these circumstances, W must include in his gross income for 1974, $94,000 (the gross contract price less the amount reasonably in dispute because of Z's claim, or $100,000—$6,000). In 1974, W must also deduct $104,000 (his costs incurred of $110,000 less $6,000, an amount equal to the amount in dispute). In 1975, W must include in gross income an

additional $2,000 ($96,000—$94,000) and must deduct $7,000 (the $1,000 of costs W incurs in such year plus the $6,000 of previously undeducted costs).

Example (2). R, a calendar year taxpayer utilizing the completed contract method of accounting, agrees to construct an office building for X for a total contract price of $10,000,000. R begins construction in 1973 and tenders the building to X in November 1975. As of November 1975, R has incurred $15,000,000 of costs which are allocable to the contract. When X examines the building, X is dissatisfied with certain aspects of the construction and demands that a substantial amount of additional work be done. The amount reasonably in dispute with respect to X's demand is $4,000,000. R is claiming an additional $2,000,000 for certain changes in contract specifications which have allegedly increased his costs. As of the end of 1975, neither dispute has been resolved. In 1976, the dispute relating to X's claim is resolved by R's performance of additional work at a cost of $3,500,000 and X's agreement to pay R an additional $400,000. In 1977, the dispute relating to R's claim is resolved by X's agreement to increase the contract price by $1,800,000. Under these circumstances R must include in his gross income for 1975 $6,000,000 ($10,000,000—$4,00,000) and must deduct from gross income $11,000,000 ($15,000,000—$4,000,000). In 1976, when the dispute relating to X's claim is resolved, R must include in gross income $4,400,000 (the $4,000,000 of the gross contract price which was excluded from gross income in 1975 by reason of X's claim plus the $400,000 by which the contract price was increased) and must deduct $7,500,000 (the previously undeducted costs of $4,000,000 plus the costs of the work performed to resolve the dispute of $3,500,000). In 1977, when the dispute relating to R's claim is resolved, R must include in gross income the $1,800,000 by which the contract price was increased in settlement of R's claim.

(5) In determining what costs are properly allocable to a long-term contract in the case of a taxpayer utilizing the completed contract method of accounting for tax purposes, the following rules shall apply:

(i) Direct material costs and direct labor costs must be treated as costs properly allocable to a long-term contract. "Direct material costs" include the costs of those materials which become an integral part of the subject matter of the long-term contract and those materials which are consumed in the ordinary course of building, constructing, installing, or manufacturing the subject matter of a long-term contract. See § 1.471-3(b) for the elements of direct material costs. "Direct labor costs" include the cost of labor which can be identified or associated with a particular long-term contract. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

(ii) The term "indirect costs" includes all costs (other than direct material costs and direct labor costs) which are incident to and necessary for the performance of particular long-term contracts. Indirect costs which must be allocated to long-term contracts include:

(a) Repair expenses of equipment or facilities used in the performance of particular long-term contracts,

(b) Maintenance of equipment or facilities used in the performance of particular long-term contracts,

(c) Utilities, such as heat, light, and power, relating to equipment or facilities used in the performance of particular long-term contracts,

(d) Rent of equipment or facilities used in the performance of particular long-term contracts,

(e) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan incurred in the performance of particular long-term contracts,

(f) Indirect materials and supplies used in the performance of particular long-term contracts,

(g) Tools and equipment not capitalized used in the performance of particular long-term contracts,

(h) Costs of quality control and inspection incurred in the performance of particular long-term contracts,

(i) Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) to the extent such taxes are attributable to labor, materials, supplies, equipment or facilities used in the performance of particular long-term contracts,

(j) Depreciation and amortization reported for financial purposes on equipment and facilities used in the performance of particular long-term contracts,

(k) Cost depletion incurred in the performance of particular long-term contracts,

(l) Administrative costs incurred in the performance of particular long-term contracts (but not including any cost of selling or any return on capital),

(m) Compensation paid to officers attributable to services performed on particular long-term contracts (other than incidental or occasional services), and

(n) Costs of insurance incurred in the performance of particular long-term contracts, such as insurance on machinery and equipment used in the construction of the subject matter of a long-term contract.

(iii) Costs which are not required to be included in costs attributable to a long-term contract include:

(a) Marketing and selling expenses, including bidding expenses,

(b) Advertising expenses,

(c) Other distribution expenses,

(d) Interest,

(e) General and administrative expenses attributable to the performance of services which benefit the long-term contractor's activities as a whole (such as payroll expenses, legal and accounting expenses, etc.),

(f) Research and experimental expenses (described in section 174 and the regulations thereunder),

(g) Losses under section 165 and the regulations thereunder,

(h) Percentage depletion in excess of cost depletion,

(i) Depreciation and amortization on idle equipment and facilities and depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(j) Income taxes attributable to income received from long-term contracts,

(k) Pension and profit-sharing contributions representing either past service costs or representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d), amounts includable in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter I of the Code,

(l) Cost attributable to strikes, rework labor, scrap and spoilage, and

(m) Compensation paid to officers attributable to the performance of services which benefit the long-term contractor's activities as a whole.

(iv) "Costs which are properly allocable to a long-term contract" do not include costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement

relating to the subject matter of the long-term contract. See paragraph (a)(3) of this section.

(6) In the case of a taxpayer who is required to allocate indirect costs to long-term contracts pursuant to subparagraph (5)(ii) of this paragraph, such costs may be allocated among long-term contracts either—

(i) By a specific identification (or "tracing") method, or

(ii) By a method of allocation utilizing burden rates, such as ratios based on direct costs, hours, or other items, or similar formulas, so long as the method employed for such allocation reasonably allocates indirect expenses among long-term contracts completed during the taxable year and long-term contracts which have not been completed as of the end of the taxable year. Indirect expenses may ordinarily be allocated to long-term contracts on the basis of direct labor and material costs, direct labor costs, direct labor hours, or any other basis which results in a reasonable allocation of such indirect costs.

(e) Severing and aggregating contracts. (1) For the purpose of clearly reflecting income, it may be necessary in some instances either to treat one agreement as several contracts or to treat several agreements as one contract. Whether an agreement should be so severed or several agreements so aggregated will depend on all the facts and circumstances. Generally, one agreement will not be treated as several contracts unless such agreement contemplates separate delivery or separate acceptance of portions of the subject matter of the contract or unless there is no business purpose for entering into one agreement rather than several agreements. However, separate delivery or separate acceptance of portions of the subject matter of a contract does not necessarily require severing of a contract. Several agreements will not generally be aggregated unless the several agreements would be treated as one contract under customary commercial practice in a taxpayer's trade or business or unless there is no business purpose for entering into several agreements rather than one agreement. An example of a factor which is evidence that two contracts entered into between the same parties should be aggregated is that one of the contracts would not have been

entered into containing the terms agreed upon but for the entering into of the other contract.

(2) The application of this paragraph may be illustrated by the following examples:

Example (1). X, a calendar year taxpayer engaged in the construction business and using a long-term contract method, enters into one contract in 1972 with A, a real estate developer, to build three houses of different designs in three suburbs of a large city. The houses are to be completed, accepted, and put into service in 1973, 1974 and 1975. The portion of the total contract price attributable to each house can reasonably be determined. In these circumstances, the contract should be severed and treated as if the agreement to build each house were a separate contract for purposes of applying X's long-term contract method.

Example (2). Y, a calendar year shipbuilder using a long-term contract method, enters into two contracts at about the same time during 1972 with M. These contracts are the product of a single negotiation. Under each contract, the taxpayer is to construct for M a submarine of the same class. Although the specifications for each submarine are similar, it is anticipated that, since the taxpayer has never constructed this class of submarine before, the costs incurred in constructing the first submarine (to be delivered in 1973) will be substantially greater than the costs incurred in constructing the second submarine (to be delivered in 1974). If the contracts are treated as separate contracts, it is estimated that the first contract would result in little or no gain, while the second contract would result in substantial profits. It is unlikely that Y would have entered into the contract to construct the first submarine for the price specified without entering into the contract to construct the second submarine. In these circumstances, the two contracts must be treated as one contract for purposes of applying Y's long-term contract method.

Example (3). Z, a calendar year taxpayer engaged in the construction business and using a long-term contract method, enters into a contract to build an office building for the Y Bank in 1973. In 1974 the first three floors of the bank building are completed and Y occupies these floors and uses them for the

conduct of its banking business. The remaining seven floors are not completed and accepted until 1975. Under the circumstances, it is clear that even though separate acceptance of portions of the subject matter of the contract has occurred, the subject matter of the contract was essentially a single unit, namely a building, and that there was a business purpose for entering into one contract rather than several contracts. Consequently, the contract ordinarily will not be severed.

(f) Changing to or from a long-term method of accounting. A taxpayer may change to or from the percentage of completion method or the completed contract method only with the consent of the Commissioner. See section 446(e) and § 1.446-1(e).

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